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No. 12391

gleo  
United States  
Court of Appeals  
For the Ninth Circuit.

AGNES M. KANNE, Executrix under the will and of the Estate  
of Fred H. Kanne, Collector of Internal Revenue of the  
United States for the District of Hawaii,  
Appellant,

vs.

AMERICAN FACTORS, LIMITED, an Hawaiian Corporation,  
Appellee.

and vs.

AMERICAN FACTORS, LIMITED, an Hawaiian Corporation,  
Appellant,

vs.

AGNES M. KANNE, Executrix under the will and of the Estate  
of Fred H. Kanne, Collector of Internal Revenue of the  
United States for the District of Hawaii,  
Appellee.

Transcript of Record  
In Two Volumes  
Volume I  
(Pages 1 to 226)

Appeals from the United States District Court,  
District of Hawaii.

FILED  
FEB 3 - 1950





No. 12391

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United States  
Court of Appeals  
For the Ninth Circuit.

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AGNES M. KANNE, Executrix under the will and of the Estate  
of Fred H. Kanne, Collector of Internal Revenue of the  
United States for the District of Hawaii,

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AMERICAN FACTORS, LIMITED, an Hawaiian Corporation,  
Appellee.

and vs.

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vs.

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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NAMES AND ADDRESSES OF ATTORNEYS  
OF RECORD

For the Plaintiff, American Factors, Limited,

SMITH, WILD, BEEBE & CADES,

Bishop Trust Building,

Honolulu, T.H.

For the Defendant, Agnes M. Kanne, etc.,

INGRAM M. STAINBACK,

United States Attorney,

District of Hawaii,

Federal Building,

Honolulu, T.H.

In the United States District Court  
For the Territory of Hawaii

Civil Action No. 419

AMERICAN FACTORS, LIMITED, an Hawaiian  
corporation,

Plaintiff,

vs.

FRED H. KANNE, Collector of Internal Revenue  
of the United States for the District of Hawaii,  
Defendant.

### COMPLAINT

To The Honorable United States District Court  
for the Territory of Hawaii:

Comes now American Factors, Limited, an  
Hawaiian corporation, Plaintiff, and complaining  
of Fred H. Kanne, Collector of Internal Revenue of  
the United States for the District of Hawaii,  
Defendant, for cause of action alleges as follows:

1. That American Factors, Limited, Plaintiff  
above named, is a corporation incorporated under  
the laws of the Territory of Hawaii, having its  
principal office in Honolulu, City and County of  
Honolulu, Territory of Hawaii, and Fred H. Kanne,  
Defendant above named, is now and at all times  
since on or about August 1, 1933, has been Collector  
of Internal Revenue of the United States for the  
District of Hawaii and is a resident of said Hono-  
lulu; and that Plaintiff claims of Defendant the

sum of \$97,134.90 with interest on \$80,254.41 thereof from December 30, 1937, and on \$16,880.49 from October 26, 1938, representing income taxes and interest thereon erroneously and illegally exacted from Plaintiff by Defendant as hereinafter more fully appears.

2. That when the United States entered the World War, H. Hackfeld & Company, Limited, an Hawaiian corporation, which was then conducting and had conducted for many years past a sugar plantation agency, general merchandise store and other businesses, and which was a large factor in the Hawaiian sugar industry and in other businesses in the Territory of Hawaii, was controlled by German interests. The Alien Property Custodian of the United States, through the seizure of German-owned stock, gained control, directly or indirectly, of approximately 68% of the capital stock of H. Hackfeld & Company, Limited.

3. The Alien Property Custodian sought and received the views of many leading business men interested in the sugar industry and in other businesses concerning what was to be done with the H. Hackfeld & Company business, and determined that the business should be continued as a unit and as a going concern and that it must be wholly Americanized. To accomplish these ends, the Alien Property Custodian prescribed a unified plan for the continuance of the business of H. Hackfeld & Company, Limited, in and by a successor corpora-



tion, American Factors, Limited, and for the complete Americanization of that business. As an integral part of the Alien Property Custodian's plan, American Factors, Limited, Plaintiff herein, was created and had a capital stock of \$5,000,000.00, divided into 50,000 shares of the par value of \$100.00 each, which shares, pursuant to said plan, were issued to H. Hackfeld & Company, Limited, and were transferred to trustees to hold until three years after the expiration of the War, and trust certificates representing and entitling the holders thereof to receive all said shares upon the termination of the trust were sold to bona fide and loyal American citizens or American corporations at a price of \$150.00 for each share, or a total stated consideration of \$7,500,000.00. Also as an integral part of this plan and in order that the same could be effectuated, a large number of persons who were later joined as defendants and respondents in the Hackfeld litigation hereinafter mentioned became and were officers and agents of H. Hackfeld & Company, Limited, or of American Factors, Limited. Some 23 persons and corporations signed a joint subscription agreement under which each individually subscribed for trust certificates representing a certain number of shares of American Factors, Limited. This joint subscription, which was for 27,000 shares, was conditioned upon this group collectively being allotted 25,000 shares. The joint subscription was accepted for a total of 25,000 shares and trust certificates were issued to and paid for by the said signers of the joint subscription for

the total of said 25,000 shares. Trust certificates representing the other 25,000 shares were issued to and paid for by approximately 615 other persons and corporations. In accordance with the plan, the total stated consideration of \$7,500,000.00, representing the purchase price of the trust certificates for the 50,000 shares, was duly paid in cash or United States bonds at par to H. Hackfeld & Company, Limited, and all of its assets and business as a going concern were on August 20, 1918, conveyed to American Factors, Limited, which assumed all liabilities of H. Hackfeld & Company, Limited, and of the business and Plaintiff thereafter continued the business as a going concern.

4. That about June, 1924, Plaintiff's directors were informed that some of the former stockholders of H. Hackfeld & Company, Limited, then dissolved, threatened to initiate litigation. At that time it was not known what form the litigation would take nor who would be the defendants. Plaintiff's Board of Directors considered the matter and authorized and instructed its President to take the necessary steps to secure counsel for Plaintiff in order to prepare for and conduct the defense in the threatened litigation. Plaintiff secured the services of prominent attorneys to represent it in the litigation.

5. That prior to the filing of the complaint in the Hackfeld litigation hereinafter mentioned, it was rumored that the 23 persons and corporations who had joined in the joint subscription agreement

referred to in paragraph 3 hereof were to be charged with fraud in connection with their participation as officers, agents, subscribers or in some other manner, in the transactions. Under these circumstances and prior to the filing of any suit, 21 of the 23 (two being dead) of those persons and corporations who had signed the joint subscription agreement agreed between themselves to prorate expenses of litigation if joined as defendants on an original per-share basis. Plaintiff was not a party to this agreement.

6. The suit of J. C. Isenberg, et al., Plaintiffs, Complainants (hereinafter called "Hackfeld Plaintiffs") vs. George Sherman . . . American Factors, Limited, et al., Defendants, Respondents (hereinafter called "Hackfeld Defendants"), and which litigation is herein called the "Hackfeld Litigation" was commenced in August, 1924. American Factors, Limited, was one of the defendants named in the Hackfeld Litigation and the 23 corporations and persons (including the representatives of the estates of the two deceased persons who had signed the joint subscription agreement) were joined as Hackfeld Defendants. The Alien Property Custodian was made a defendant, and there were some defendants named who the plaintiffs alleged should really have joined as coplaintiffs.

7. The Hackfeld Litigation was brought in equity and the complaint in the action filed in California was entitled "Complaint for Accounting, Relief

against Fraud and Conspiracy, for Damages and Incidental Relief." The gist of the complaint affirmed the sale and transfer of the assets of H. Hackfeld & Company, Limited, to American Factors, Limited, and alleged that the sale and transfer were the result of conspiracy, collusion and fraudulent connivance on the part of certain of the Hackfeld Defendants whereby they caused to be sold to American Factors, Limited, the assets and profitable business of H. Hackfeld & Company, Limited, at a price far below its alleged intrinsic value in fraud of and to the financial injury of the Hackfeld Plaintiffs. The object of the suit was to claim damages in the amount of \$10,000,000.00 against American Factors, Limited, and the other Hackfeld Defendants (except the nominal defendants) and that American Factors be ordered by the court to hold all of the assets and business which it had received from H. Hackfeld & Company, Limited, subject to the satisfaction of any judgment which was obtained by the Hackfeld Plaintiffs in the suit. In addition, a claim for \$2,500,000.00 damages was made against American Factors, Limited, alone. The Hackfeld Plaintiffs prayed that judgment be entered against American Factors, Limited, together with the other Hackfeld Defendants (except the nominal defendants) in favor of the Hackfeld Plaintiffs for such sum as the court might find them entitled to receive, and also that judgment be entered against American Factors, Limited, specifically for such amount as the court might find the

Hackfeld Plaintiffs had been injured by the alleged mismanagement and alleged breach of fiduciary duties alleged in the complaint to have been committed by American Factors, Limited, because of the acts of its officers or agents.

8. The attorneys employed by American Factors, Limited, investigated the facts and matters pertaining to the Hackfeld Litigation and prepared a joint answer on behalf of American Factors, Limited, and the other Hackfeld Defendants, except the Alien Property Custodian and the nominal defendants, and signed and filed the answer on behalf of such Hackfeld Defendants. The case went to trial and was on trial in the Superior Court of the State of California at San Francisco for many months. At its conclusion the trial judge filed a terse memorandum substantially stating that he was of the opinion, among other things, that (1) no actual fraud on the part of the Hackfeld Defendants was shown, and (2) no constructive fraud existed. Findings of fact were prepared by counsel, approved by the court, and judgment for the Hackfeld Defendants was entered on January 31, 1927.

9. The Hackfeld Plaintiffs in due course perfected an appeal to the Supreme Court of the State of California where further hearings and arguments were had in the matter on appeal. The California Supreme Court rendered its opinion on April 30, 1931 (298 Pac. 1004-1026) sustaining the findings of the trial court, and held that the Hackfeld Plaintiffs



were not entitled to damages or any other relief. Thereafter, a petition for rehearing was filed and denied; and thereafter in the year 1931 a petition was filed by the Hackfeld Plaintiffs praying that the remittitur be recalled and that the case be reconsidered. The Supreme Court of the State of California held in an opinion rendered January 29, 1932, that the remittitur was not to be recalled. The Hackfeld Litigation was terminated in the year 1932 when the final decision in that cause was rendered in said year 1932.

10. American Factors, Limited, paid from time to time all of the expenses of the Hackfeld Litigation which totaled \$568,607.76. These outlays were carried by American Factors, Limited, on its records as deferred items. In the early part of the Hackfeld Litigation and by about the end of the year 1925 and many years before there was any final determination of the Hackfeld Litigation, substantially all of the total amount of the expenses then incurred, to wit, expenses totaling the sum of \$396,812.50, were prorated among 22 of the Hackfeld Defendants who were charged with fraud and conspiracy in the Litigation proportionately to their original stock holdings in American Factors, Limited, and these 22 Hackfeld Defendants by about the end of the year 1925 paid to American Factors, Limited, said sum of \$396,812.50 on account of litigation expenses, but the question as to whether or not these Hackfeld Defendants or American Factors, Limited, would ultimately pay these expenses was not then deter-

mined. The other approximately 615 original stockholders of American Factors, Limited, paid no part of the Hackfeld Litigation expenses. In the calendar year 1932, American Factors, Limited, paid \$87,992.50 (which was a part of the total sum of \$568,607.76) as expenses for the conclusion of the Hackfeld Litigation; and also, after the final conclusion of the Hackfeld Litigation and in the year 1932, paid on account of Hackfeld Litigation expenses the said sum of \$396,812.50 to those Hackfeld Defendants who had theretofore paid the same to Plaintiff.

11. The Hackfeld Litigation was litigation in which the Hackfeld Plaintiffs claimed damages for alleged conspiracy and fraudulent and tortious acts, which came to a final conclusion in the calendar year 1932, and in which the final judgment was that no actual fraud was shown and no constructive fraud existed, and the Hackfeld Plaintiffs were wholly unsuccessful and the Hackfeld Defendants were wholly successful in this Litigation.

12. If the court had ultimately held in the Hackfeld Litigation that certain of the Hackfeld Defendants other than American Factors, Limited, were guilty of conspiracy and fraudulent and tortious acts and such acts of other Hackfeld Defendants resulted in a judgment being procured against all of the Hackfeld Defendants, including American Factors, Limited, because of its constructive liability for the acts of the others, then and in that event

the conspiracy, fraudulent and tortious acts of the other Hackfeld Defendants would have been the proximate cause of an injury to American Factors, Limited, and as between American Factors, Limited, and the other Hackfeld Defendants American Factors would have a good and enforceable cause of action against said other Hackfeld Defendants for the whole of the legal expenses expended by American Factors, Limited, in defense of that suit. The question concerning this possible liability could not be finally determined until the conclusion of the litigation in 1932.

13. The court in the Hackfeld Litigation determined in proceedings which became final in the year 1932 that there was no fraud and no conspiracy and as all acts complained of were for the benefit of and done in connection with the business of American Factors, American Factors, Limited, became liable in the year 1932 and was liable in such year, either in law or in equity, as between itself and the other Hackfeld Defendants to pay all of the costs and expenses of defending the Hackfeld Litigation, and the whole amount of the same, to wit, the sum of \$568,607.76 accrued and became and was an allowable deduction from Plaintiff's gross income for the calendar year 1932 for the purpose of computing its net income under the Revenue Act of 1932.

14. That on or about February 21, 1931, Plaintiff made a loan of \$50,000.00 to Henry Waterhouse

Trust Company, Limited, an Hawaiian corporation, and received the note of that corporation in the principal sum of \$50,000.00 as evidence of said debt. The debt was payable out of assets of Henry Waterhouse Trust Company, Limited, after other liabilities incurred or to be incurred were paid in full. At the time the loan was made, Plaintiff expected to receive payment of the same. In July, 1932, after full investigation and after reappraisal of the assets of Henry Waterhouse Trust Company, Limited, had been made, Plaintiff determined that said debt of \$50,000.00 became worthless in 1932 and charged off on its books the amount of \$50,000.00 on account of this indebtedness in the year 1932.

15. That during the calendar year 1932, Plaintiff paid the total sum of \$4,063.33 to widows and children of deceased employees, which amount was paid as additional compensation for services rendered by employees prior to their death and constituted reasonable compensation for services rendered; that Plaintiff had for the year 1932 and continuously for many years prior thereto a policy of making payments to the widows and children of deceased employees, which payments were voluntary and were determined by Plaintiff's Board of Directors which considered, in determining the amount of the pension, the requirements of the widows and children and the length and value of the service of the deceased employee; that this policy was well-known to Plaintiff's employees, and it is reasonable to assume that the employees considered all such pay-

ments made as an additional reward for faithful service to the company; that such payments made in the year 1932 constituted reasonable additional compensation for services rendered by employees and were an ordinary and necessary business expense which accrued during the year 1932.

16. That on or before March 15, 1933, Plaintiff filed in the office of the Collector of Internal Revenue of the United States for the District of Hawaii at Honolulu, Territory of Hawaii; its income tax return for the calendar year 1932, which return showed that no amount was due and payable by said Plaintiff on account of income taxes for income received during the calendar year 1932; that in said return Plaintiff deducted as ordinary and necessary business expenses accrued during the calendar year 1932 the said sum of \$568,607.76 for Hackfeld Litigation costs and expenses, and also deducted the sum of \$50,000.00 on account of said bad debt of Henry Waterhouse Trust Company, Limited, and also deducted the sum of \$4,063.33 so paid as pensions to widows and children of former deceased employees.

17. That Plaintiff prepared and filed its income tax returns on the calendar-year and accrual bases for the year 1932 and for prior years.

18. That a representative of the Commissioner of Internal Revenue made an examination of said return for the calendar year 1932 and proposed the disallowance of certain deductions claimed by it,



and asserted that an income tax was due from Plaintiff, to which proposed disallowance of deductions Plaintiff protested within the time and in the manner as prescribed by law and the Regulations.

19. That thereafter the Commissioner of Internal Revenue reviewed the matter and tentatively determined that Plaintiff was subject to an income tax for the calendar year 1932 and Plaintiff protested the grounds and conclusions of the Commissioner in that behalf within the time and in the manner as prescribed by law and the Regulations.

20. That thereafter by letter dated September 3, 1937, symbols: IT:E:7-8 GVR-90D, addressed to Plaintiff, the Commissioner of Internal Revenue stated that the determination of the income tax liability of Plaintiff for the calendar year 1932 disclosed a deficiency of \$62,438.82; that in and by said letter said Commissioner disallowed as a deduction all but \$87,992.50 of the Hackfeld Litigation expenses and stated that of the amounts paid by Plaintiff on account of the Hackfeld Litigation expenses, only the amount of \$87,992.50 accrued during the year 1932. The Commissioner also disallowed as a deduction said bad debt deduction in the sum of \$50,000.00, but the Commissioner allowed as a deduction said sum of \$4,063.33 paid as pensions to widows and children of deceased employees.

21. That thereafter the amount of \$62,438.82 as and for an income tax for the calendar year 1932 was assessed against Plaintiff, and Defendant above

named demanded that Plaintiff pay the same, together with an additional amount of \$17,815.59 as interest thereon; that said tax and interest totaling \$80,254.41 was paid by Plaintiff to Defendant on December 30, 1937.

22. That the whole amount of such claimed income tax so paid resulted from the disallowance as a deduction from its gross income of Hackfeld Litigation expenses in the sum of \$480,615.26 and from the disallowance as a deduction from its gross income as a bad debt of the said sum of \$50,000.00 which Plaintiff determined to be worthless and wrote off its books in the calendar year 1932.

23. That on or about April 5, 1938, Plaintiff filed with the Commissioner of Internal Revenue through the Collector of Internal Revenue, his agent for that purpose, a claim for refund (a copy of which is attached hereto and marked Exhibit "A") covering the calendar year 1932 on Form 843, as prescribed by the Commissioner of Internal Revenue, for the refund of said \$80,254.41, which claim was rejected by the Commissioner on or about December 2, 1938.

24. That by letter dated June 29, 1938, the Commissioner of Internal Revenue stated that the determination of the income tax liability of Plaintiff for the calendar year 1932 disclosed an additional deficiency of \$12,657.68, and this additional claimed deficiency resulted wholly from the Commissioner reversing his prior determination that (a) \$87,992.50 of the Hackfeld Litigation expenses accrued

during the year 1932 and was an allowable deduction, and (b) that the total sum of \$4,063.33 paid as pensions was an allowable deduction.

25. That on June 29, 1938, the additional amount of \$12,657.68 as and for an additional income tax for the calendar year 1932 was assessed against Plaintiff and Plaintiff received from Defendant a demand for payment of the same, together with an additional amount of \$4,222.81 as interest thereon; that Plaintiff paid said tax and interest totaling \$16,880.49 to Defendant on October 26, 1938.

26. That on or about December 22, 1938, Plaintiff filed with the Commissioner of Internal Revenue through the Collector of Internal Revenue, his agent for that purpose, a claim for refund (a copy of which is attached hereto and marked Exhibit "B") on Form 843, as prescribed by the Commissioner of Internal Revenue, for the additional amount of \$16,880.49 so paid by Plaintiff to Defendant on October 26, 1938; that more than six months have elapsed since the filing of said claim and the Commissioner has neither accepted nor rejected the same.

27. That no amount has been paid to said Plaintiff on account of said two sums totaling \$97,134.90 claimed as taxes and interest thereon and so illegally assessed, demanded and collected by said Defendant from said Plaintiff.

Wherefore, Plaintiff demands judgment against



Defendant in the sum of \$97,134.90 with interest on \$80,254.41 thereof from December 30, 1937, and with interest on \$16,880.49 thereof from October 26, 1938.

Dated: Honolulu, T.H., this 6th day of January, 1940.

/s/ U. E. WILD,

Attorney for Plaintiff.

Of Counsel:

SMITH, WILD, BEEBE & CADES.

Territory of Hawaii,

City and County of Honolulu—ss.

Comes now S. M. Lowrey who, being first duly sworn, on oath deposes and says:

That he is Treasurer of American Factors, Limited, Plaintiff named in the foregoing Complaint; that said Plaintiff has authorized the signing and filing of the foregoing Complaint; that he has read the foregoing Complaint and that the matters and things therein stated are true to the best of his knowledge and belief.

/s/ S. M. LOWREY.

Subscribed and sworn to before me this 6th day of January, 1940.

[Seal] /s/ ABRAHAM K. KEKIPI,  
Notary Public, First Judicial Circuit, Territory of  
Hawaii.

## EXHIBIT "A"

## Claim

Form 843

Treasury Department  
Internal Revenue Service

To Be Filed With the Collector Where Assessment  
Was Made or Tax Paid

The Collector will indicate in the block below the kind of claim filed, and fill in the certificate on the reverse side.

- ☐ Refund of Tax Illegally Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to estate or income taxes).

[Collector's Stamp]: Collector of Internal Revenue Received Apr. 5, 1938, Honolulu, Hawaii.

Territory of Hawaii,  
City and County of Honolulu—ss.

Name of taxpayer or purchaser of stamps American Factors, Limited.

Business address Fort and Queen Streets, Honolulu, Territory of Hawaii.

Residence.....

The deponent, being duly sworn according to law, deposes and says that this statement is made on

behalf of the taxpayer named, and that the facts given below are true and complete:

1. District in which return (if any) was filed  
Collection District of Hawaii.
2. Period (if for income tax, made separate form  
for each taxable year) from January 1, 1932, to  
December 31, 1932.
3. Character of assessment or tax Income tax.
4. Amount of assessment, \$80,254.41; dates of pay-  
ment December 30, 1937.
5. Date stamps were purchased from the Govern-  
ment.....
6. Amount to be refunded Tax and Interest  
\$80,254.41.
7. Amount to be abated (not applicable to income  
or estate taxes) \$. .....
8. The time within which this claim may be legally  
filed expires, under Section 322(b)(1) of the  
Revenue Act of 1932, on December 30, 1939.

The deponent verily believes that this claim should be allowed for the following reasons:

See statement attached hereto and made a part hereof, pages 1 to 17, inclusive.

[Pages 20 to 37 of printed record.]

AMERICAN FACTORS,  
LIMITED,

By /s/ S. M. LOWREY,  
Its Treasurer.

Sworn to and subscribed before me this 5th day of April, 1938.

[Seal]     /s/ ABRAHAM K. KEKIPI,  
Notary Public, First Judicial Circuit, Territory of  
Hawaii.

Reasons for Allowing the Claim of American Factors, Limited, for Refund of Income Tax Paid for the Calendar Year 1932, and Forming a Part of Its Claim for Refund on Form 843

American Factors, Limited, hereinafter called the "Taxpayer," filed an income tax return in the office of the Collector of Internal Revenue at Honolulu, Territory of Hawaii on or before March 15, 1933, for the calendar and taxable year 1932; said income tax return, hereinafter called the "Return," showed that no amount was due and payable by said Taxpayer on account of income taxes for income received during the calendar year 1932. A representative of the Commissioner of Internal Revenue made an examination of the said Return for the calendar year 1932 during the year 1934, and in and by his report dated September 6, 1934, proposed the disallowance of certain deductions, etc., and asserted that the total income tax liability of said Taxpayer for the calendar year 1932 was the sum of \$51,270.97.

On or about March 30, 1935 (within the time lawfully granted to said Taxpayer to file such protest) said Taxpayer filed with the Internal Revenue Agent in Charge its protest dated March 29, 1935, to the

proposal to assess the amount of \$51,270.97 or any amount as a claimed additional Federal income tax for the calendar year 1932.

By his tentative deficiency letter dated April 14, 1937, Symbols: IT:E:7-8 GVR, addressed to American Factors, Limited, Honolulu, Territory of Hawaii, the Commissioner of Internal Revenue stated that Taxpayer's net income as corrected for the calendar year 1932 was \$459,684.38, and tentatively determined that Taxpayer was subject to an additional income tax in the sum of \$63,206.60 for the calendar year 1932.

On or about May 29, 1937 (within the time granted lawfully to said Taxpayer to file a protest to said deficiency letter dated April 14, 1937) said Taxpayer filed a protest dated May 28, 1937, to the assessment of any additional tax against the Taxpayer as and for an income tax for the calendar year 1932.

By letter dated September 3, 1937, Symbols: IT:E:7-8 GVR 90D, addressed to American Factors, Limited, Honolulu, Territory of Hawaii, the Commissioner of Internal Revenue stated that the determination of the income tax liability of Taxpayer for the taxable year ended December 31, 1932, disclosed a deficiency of \$62,438.82, as shown in the statement attached to said letter. In said statement Taxpayer's net income as corrected was stated to be the sum of \$454,100.54.

Thereafter the amount of \$62,438.82 as and for an income tax for the year 1932 was assessed against Taxpayer, and Taxpayer received a demand from

the Collector of Internal Revenue for the District of Hawaii for payment of the same, together with the additional amount of \$17,815.59 as interest thereon; said tax and interest totaling \$80,254.41 was paid to the Collector of Internal Revenue for the District of Hawaii by Taxpayer on December 30, 1937.

The whole income tax claimed in said letter dated September 3, 1937, and so assessed and paid by Taxpayer results from (a) the disallowance as a deduction of Hackfeld Litigation expenses in the sum of \$480,615.26, and (b) the disallowance as a deduction as a bad debt of the sum of \$50,000.00 loaned to Henry Waterhouse Trust Company, Limited, which the Taxpayer determined to be worthless and wrote off its books in the calendar year 1932.

Taxpayer contends that the Commissioner erred in disallowing these claimed deductions.

## I.

Taxpayer is entitled to a deduction for the calendar year 1932 of all of the Hackfeld Litigation expenses.

At the time of the entrance of the United States into the World War, H. Hackfeld & Company, Limited, an Hawaiian corporation, which then was conducting and for many years past had conducted a sugar plantation agency, general merchandise and other businesses, was controlled by German interests. This corporation was a large factor in the Hawaiian



sugar industry and in other businesses in the Territory of Hawaii. The Alien Property Custodian of the United States seized the German owned stock in the company and in a holding company which owned a large block of the stock in the company, and thereby gained control, directly or indirectly, of about sixty-eight per cent of the stock of H. Hackfeld & Company, Limited.

After thoroughly considering the problems involved, the Alien Property Custodian determined that the business should be continued as a unit and as a going concern, and of course that it must be wholly Americanized. To accomplish these ends, the Alien Property Custodian prescribed a unified plan for the continuance of the business of H. Hackfeld & Company, Limited, in and by a successor corporation, American Factors, Limited, and for the complete Americanization of that business, which plan was completely effectuated. As an integral part of the Alien Property Custodian's plan, American Factors, Limited, Taxpayer herein, was created and had a capital stock of \$5,000,000.00, divided into 50,000 shares of the par value of \$100.00 each, which shares, pursuant to the plan of the Alien Custodian, were sold to bona fide and loyal American citizens or American corporations at a price of \$150.00 each, or a total stated consideration of \$7,500,000.00 which was paid to H. Hackfeld & Company, Limited, and all assets and business as a going concern of H. Hackfeld & Company, Limited, were on August 20, 1918, conveyed to

American Factors, Limited, which assumed all liabilities of H. Hackfeld & Company, Limited, and of the business, and thereafter continued the business.

Also, as an integral part of this plan and in order that the same could be effectuated, a large number of persons (who were later made Defendants in the Hackfeld Litigation hereinafter mentioned) became and were officers or agents of H. Hackfeld & Company, Limited, or of American Factors, Limited.

Some twenty-three persons and corporations signed a subscription agreement under which each individually subscribed for a certain number of shares of American Factors, Limited, which totaled 27,000 shares, and the whole subscription was conditioned upon the group collectively being allotted at least 25,000 shares. This joint subscription was accepted for a total of 25,000 shares. The other 25,000 shares were subscribed by approximately 634 other persons and corporations. The Alien Property Custodian knew and approved of the joint subscription and the allotment of 25,000 shares to its members was exactly what he desired because it insured to Taxpayer and to the other 634 odd subscribers stability, credit, leadership and skilled and experienced management.

About June, 1924, the directors of American Factors, Limited, were informed that some of the former stockholders of H. Hackfeld & Company, Limited (then dissolved) threatened to initiate litigation. At that time it was not known what form



the litigation would take nor who would be defendants. The Board of Directors of American Factors, Limited, considered the matter and authorized and instructed its president to take the necessary steps to secure counsel for Taxpayer in order to prepare for and conduct a defense in the threatened litigation. The services of Mr. Oscar Sutro, of San Francisco, a very eminent attorney, were secured by Taxpayer shortly thereafter and other eminent attorneys were subsequently engaged to assist him in the threatened litigation.

It was rumored that the twenty-three persons and corporations who had joined in the joint subscription were to be charged with fraud in connection with their participation as officers, agents or subscribers, etc., in the transactions. Under these circumstances and prior to the filing of any suit, twenty-one of the twenty-three (two being dead) of those persons and corporation that had signed the joint subscription agreement agreed between themselves to prorate expenses of litigation, if joined as defendants, on an original subscription per share basis. American Factors, Limited, was not a party to this agreement.

The suit of J. C. Isenberg, et al., Plaintiffs, Complainants, hereinafter called "Plaintiffs," vs. George Sherman . . . American Factors, Limited, et al., Defendants, Respondents, hereinafter called "Defendants," and which litigation is herein called the "Hackfeld Litigation," was commenced in August, 1924. American Factors, Limited, Taxpayer

herein, was one of the Defendants named in the suit and the twenty-three corporations and persons (including the estates of two deceased) that had signed the joint subscription agreement were joined as Defendants, the Alien Property Custodian was made a Defendant, and there were some Defendants named whom Plaintiffs alleged should really have been joined as coplaintiffs.

The complaint was an action in equity and was entitled "Complaint for Accounting, Relief against Fraud and Conspiracy, for Damages and Incidental Relief." The gist of the complaint affirmed the sale and transfer of the assets of H. Hackfeld & Company, Limited, to Taxpayer and alleged that the sale and transfer were the result of conspiracy, collusion and fraudulent connivance on the part of certain of the Defendants whereby they caused to be sold to American Factors, Limited, the assets and profitable business of H. Hackfeld & Company, Limited, at a price far below its alleged intrinsic value, in fraud and to the financial injury of Plaintiffs. The object of the suit was to claim damages in the amount of \$10,000,000.00 against Taxpayer and other Defendants, and that Taxpayer be ordered by the court to hold all of the assets and business which it had received from H. Hackfeld & Company, Limited, subject to the satisfaction of any judgment which was obtained by Plaintiffs in the suit. In addition, a claim for \$2,500,000.00 was made against Taxpayer alone. Plaintiffs prayed that judgment be entered against Taxpayer, together with other

Defendants, in favor of Plaintiffs for such sum as the court might find Plaintiffs entitled to, and also that judgment be entered against Taxpayer specifically for such amount as the court might find Plaintiffs had been injured by the alleged mismanagement and alleged breach of fiduciary duties alleged to have been committed by Taxpayer.

The attorneys employed by Taxpayer investigated the facts and matters pertaining to the litigation and prepared a joint answer on behalf of Taxpayer and other Defendants and signed the answer on behalf of such Defendants. The case went to trial and was on trial in the Superior Court of the State of California at San Francisco for many months. At the conclusion of the trial, the trial judge filed a terse memorandum substantially stating that he was of the opinion, among other things, that (1) no actual fraud on the part of Defendants was shown, and (2) no constructive fraud existed. Findings of fact were prepared by counsel, approved by the court and judgment for Defendants was entered on January 31, 1927.

The Plaintiffs in due course perfected an appeal to the Supreme Court of the State of California where further hearings and arguments were had in the matter on appeal. The California Supreme Court rendered its opinion on April 30, 1931 (298 Pac. 1004-1026) sustaining the findings of the trial court which were in favor of Defendants on all points, and held that Plaintiffs were not entitled to damages or any other relief.

Thereafter a petition for rehearing was filed and denied; and thereafter in the year 1931 a petition was filed by Plaintiffs praying that the remittitur be recalled and that the case be reconsidered. The Supreme Court of the State of California held in an opinion rendered January 29, 1932, that the remittitur was not to be recalled and the decision in the case in favor of Defendants became the final decision in the year 1932.

The Hackfeld Litigation was, therefore, litigation in which Plaintiffs claimed damages for alleged conspiracy and fraudulent and tortious acts, which came to a final conclusion in 1932, and in which the final judgment was that no actual fraud was shown and no constructive fraud existed, and the Plaintiffs were wholly unsuccessful and the Defendants were wholly successful.

As it was definitely and finally determined in 1932 that Taxpayer had successfully defended the suit, all expenditures by Taxpayer in connection with the defense of such a suit were, therefore, ordinary and necessary business expenses, which are allowable as deductions to Taxpayer. *Kornhauser v. United States* (276 U.S. 145), 72 Law Ed. 505, at 506. In that case the Supreme Court held that an expenditure for counsel fees in defending a suit for accounting by a former business partner is deductible as a business expense in computing taxable income. The court states (page 506) that where a suit or action against the Taxpayer is directly connected with or proximately resulted from his busi-



ness, the expense incurred in defending the suit is a business expense which is an allowable deduction within the meaning of the income tax law.

See also *The Super-Heater Company*, 12 B.T.A. 5, at 11, 12. In that case the amount paid by Taxpayer in compromise of a suit for damages for alleged wrongful cancellation of stock was held to be a business expense and a proper deduction. The authorities are uniform in holding that expenses paid in defending a suit for damages are business expenses and as such are allowable deductions. See *Murphy Oil Company*, 15 B.T.A. 1195, at 1201.

The *Hackfeld* case was a suit praying damages for alleged fraudulent and improper acts. The Plaintiffs prayed that all of the property that was acquired by *American Factors, Limited*, from *H. Hackfeld & Company, Limited*, should be held answerable to pay and satisfy any judgment for damages which was obtained against any of the Defendants. In addition, a separate claim for damages in the amount of \$2,500,000.00 was made against Taxpayer on account of alleged mismanagement of the business. It is obvious that the total cost of the defense of such a suit is an ordinary and necessary business expense of Taxpayer and as such is an allowable deduction under the authorities hereinbefore cited.

Taxpayer paid all of the expenses of the *Hackfeld* Litigation which totaled \$568,607.76. These expenses were carried by Taxpayer on its records as deferred expense items. In the early years of the

litigation and by about the end of the year 1925 and many years before there was any final decision in the Hackfeld Litigation, substantially all of the total amount of the expenses then incurred were prorated among twenty-two of the Defendants who were charged with fraud in the litigation in proportion to their original stockholdings in Petitioner. These twenty-two Defendants had originally acquired a total of 22,675 shares out of the entire 50,000 shares originally issued by Taxpayer. These twenty-two Defendants then and by about the end of the year 1925 paid to Taxpayer the total sum of \$396,812.50 on account of the litigation expenses, but the question as to whether or not they or Taxpayer would ultimately pay this expense was not then determined. The other 634 odd stockholders who had originally acquired some 27,325 shares of Taxpayer's stock paid no part of the litigation expenses.

If the court had ultimately held that certain of the Defendants other than Taxpayer were guilty of fraudulent acts and Taxpayer was not, and that such fraudulent acts resulted in a judgment being procured against all the Defendants, including Taxpayer, because of its constructive liability for the acts of the others, then obviously, the alleged fraudulent acts of these other Defendants would have been the proximate cause of an injury to Taxpayer; and as between themselves and Taxpayer, the Taxpayer should legally pay no part of the expenses of defending the suit. For a holding to this effect, see *Blackwell Oil and Gas Co. v. Commissioner of In-*

ternal Revenue, 60 Fed.(2d) 257. In this case the Taxpayer claimed the deduction as a business expense of an amount which it had paid in settlement of a suit which was predicated upon an alleged conspiracy entered into between the Defendants in the action as directors of the corporation. The court stated at page 258:

“The defendants in the action, as directors of the corporation, had no authority to enter into any unlawful conspiracy. . . . While the alleged acts committed in furtherance of the conspiracy were largely acts committed by the defendants as officers and directors of the corporation, the gist of the action was a conspiracy. It seems clear to us that the petitioner was not liable for the cause of action compromised and the amount paid in compromise was neither an ordinary or necessary expense of the corporation.”

In the event that the court had held in the Hackfeld case that the officers and stockholders of the corporation who had acted as agents, officers, etc., in performing the acts complained of had been guilty of performing fraudulent and improper acts, obviously these Defendants would not as agents, officers or directors or otherwise have any authority from American Factors, Limited, to enter into any conspiracy to defraud or to perform fraudulent acts. If the Court had so held, American Factors, Limited, must disavow any liability for the other Defendants' acts and would not as between itself and the other Defendants be legally liable for the

expenses of defending the litigation. But as the court finally determined that there was no fraud and no conspiracy and as all acts complained of were for the benefit of and done in connection with Taxpayer's business, there was an absolute legal liability upon Taxpayer to pay all of these costs of defending such litigation.

A corporation is liable for and may employ its funds in the defense of legal proceedings, even though brought against the officers or members of its committees, etc., where it has an interest in and is affected by the litigation. See *Fletcher Cyclopedia Corporations*, Permanent Edition, Section 2507.

*Mitchell v. Beachy*, 202 Pac. 628 (110 Kans. 60). In this case it was held that a corporation—The State Bank of Esbon—had a duty to keep its stock records straight and accurate, and consequently, it could lawfully pay and had a legal obligation to pay all of the attorneys' fees for defending a suit brought against one Richard Beachy, Cashier, of The State Bank of Esbon, and also The State Bank of Esbon and also Richard Beachy personally in which such matter was involved. In that case, as in our case, there were other parties than the defending corporation and the decision of the court sustains as proper the payment of the whole fee for the defense of all parties named as defendants in the suit.

On page 3 of the statement annexed to the ninety-day letter, the following statement is made:



“The record fails to disclose, however, that you were under any obligation to reimburse your co-defendants for the amounts paid by them during the years 1924 and 1925. . . .”

In the year 1932, after final determination of the Hackfeld Litigation, American Factors, Limited, paid the sum of \$396,812.50 as payment by itself of expenses of litigation to the codefendants who had paid the same by about the end of the year 1925. In this connection, the facts as shown and the authorities hereinbefore cited show clearly that in 1932, when the Hackfeld case was finally terminated, American Factors, Limited, then for the first time had a legal obligation to the other Defendants to pay all of the expenses of the litigation. This is true, even though there were parties other than the corporation joined as defendants in the litigation, as see *Mitchell v. Beachy* (supra), *Fletcher Cyclopedia Corporations* (supra) and other authorities cited. In this case there is no question but that American Factors, Limited, had an interest in and was affected by the litigation, and as stated in *Fletcher*, Section 2507 (supra), under such circumstances, a corporation is liable for and may employ its funds in the defense of legal proceedings, even though brought against the officers and members of the committee.

It is also a well established rule that any one person or persons who, having an interest in a trust fund (or having an interest in a corporation) at his or their own expense, takes proper proceedings to

save the funds from destruction or to restore the fund is entitled to reimbursement either out of the fund itself or by proportional contribution from those who accept the benefit of his efforts. This is a well established legal and equitable principle. Under this theory of law, as the defense of the suit was wholly successful, the Defendants who contributed toward the payment of fees, etc., are legally and equitably entitled to full reimbursement out of the corporate funds for all of such expenses. This general theory is affirmed in *Trustees of the Internal Improvement Fund v. Greenough*, 26 Law Ed. 1157 (105 U.S. 527).

This case in the Supreme Court of the United States shows that in 1932, upon the successful conclusion of the Hackfeld Litigation, there arose a definite legal and equitable liability upon American Factors, Limited, in favor of the other Defendants in the suit, to pay all costs and expenses of defending the suit. This is true, even though the corporation or trust is not made a party to the action. It seems as though nothing further should be needed as legal authority upon which to grant the allowance of the claimed deduction.

Further, the total additional amount of the Hackfeld Litigation expenses, to-wit, \$171,795.26, Taxpayer contends is also an allowable deduction for the year 1932. The Commissioner in the ninety-day letter states that of the amount paid by Taxpayer only \$87,992.50 accrued during the year 1932 and only allowed this sum as a deduction for said year.

Taxpayer is on the accrual basis and the Commissioner apparently contends that the other litigation expenses accrued in prior years. The Commissioner cited Searles Real Estate Trust, 25 B.T.A. 1115 and cases cited therein in this connection.

The Searles case is not in point here because the Searles Real Estate Trust was the only party that could have been obligated to pay the fees which were incurred as absolute obligations in certain years but not paid until a later year because of lack of funds. The question as to whether some other party was liable as between itself and the Searles Trust was not involved.

In *United States v. Anderson*, 70 Law Ed. 347, at 351 (269 U.S. 422), which was cited in the Searles case, the Supreme Court shows that before an expense or tax has accrued all the events must occur which fix the amount and determine the liability of the taxpayer to pay it.

The final determination as to whether American Factors, Limited, was liable for this litigation expense as between itself and the other Defendants in the case could only be determined at the time that the Hackfeld Litigation was finally concluded in 1932, and it depended upon the final result of that litigation. In this connection, it must not be forgotten that the gravamen of the complaint was that the Defendants other than American Factors, Limited, were guilty of fraudulent and tortious acts as a result of which American Factors, Limited, obtained a benefit. If, as a result of the litigation, it was

finally determined that the other Defendants had performed such fraudulent and improper acts, then as between such Defendants and American Factors, Limited, the fraudulent Defendants and not American Factors, Limited, would be liable for the full amount of all of the Hackfeld Litigation expenses. Under such circumstances, under the rule in *United States v. Anderson* (supra), American Factors, Limited, could not accrue these expenses until in the year 1932 when the litigation was finally concluded.

## II.

Taxpayer is entitled to deduct as a bad debt the amount of \$50,000.00 loaned to Henry Waterhouse Trust Company, Limited, and written off in 1932.

On or about February 21, 1931, Taxpayer made a loan of \$50,000.00 to Henry Waterhouse Trust Company, Limited, and received the note of that corporation in the principal sum of \$50,000.00 as evidence of said debt. The debt was payable out of assets of Henry Waterhouse Trust Company, Limited, after other liabilities incurred or to be incurred by that corporation were paid in full. At the time the loan was made, Taxpayer expected to receive payment of the same.

In July, 1932, Taxpayer was informed by Mr. M. B. Henshaw, Vice President and Manager of Henry Waterhouse Trust Company, Limited, that an exhaustive reappraisal of the assets of that corporation had been made and that the assets did not

have sufficient value to pay the prior claims and that this promissory note was worthless; that the debt of \$50,000.00 evidenced by said note was a bad debt and was worthless and that Taxpayer might claim it as a bad debt for the year 1932. Taxpayer determined that the debt became worthless in the year 1932 and charged off the amount of \$50,000.00 on account of this indebtedness in the year 1932 and claimed the amount thereof as a deduction in its income tax return.

Taxpayer is informed that the facts occurring subsequent to the year 1932 further bear out the contention that said debt became worthless in the calendar year 1932, and respectfully contends that the deduction is allowable in 1932.

### Conclusion

A hearing on this claim for refund is respectfully requested in Washington, D. C. Taxpayer's Attorney and Attorney-in-Fact, Mr. U. E. Wild, is planning to be in Washington, D. C., sometime during the months of May and June, 1938, the exact date of his arrival there not yet being ascertainable. It is respectfully requested that you fix the time of such hearing at approximately such time during the months of May and June as he will hereinafter in writing request.



## EXHIBIT "B"

## Claim

Form 843

Treasury Department  
Internal Revenue ServiceTo Be Filed with the Collector Where Assessment  
Was Made or Tax Paid

The Collector will indicate in the block below the kind of claim filed, and fill in the certificate on the reverse side.

- ☐ Refund of Tax Illegally Collected.
- ☐ Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
- ☐ Abatement of Tax Assessed (not applicable to estate or income taxes).

[Collector's Stamp]: Collector of Internal Revenue Received Dec 22, 1938 Honolulu, Hawaii

Territory of Hawaii

County of Honolulu—ss:

Name of taxpayer or purchaser of stamps American Factors, Limited

Business address Fort and Queen Streets, Honolulu, Territory of Hawaii

Residence .....

The deponent, being duly sworn according to law, deposes and says that this statement is made on

1. District in which return (if any) was filed Collection District of Hawaii
2. Period (if for income tax, make separate form for each taxable year) from January 1, 1932, to December 31, 1932
3. Character of assessment or tax Income Tax
4. Amount of assessment, \$12,657.68; dates of payment October 26, 1938.
5. Date stamps were purchased from the Government .....
6. Amount to be refunded Tax, \$12,657.68; interest, \$4,222.81 \$16,880.49
7. Amount to be abated (not applicable to income or estate taxes) \$. .....
8. The time within which this claim may be legally filed expires, under Section 322 (b) (1) of the Revenue Act of 1932, on October 26, 1940

See statement attached hereto and made a part hereof, pages 1 to 9, inclusive.

AMERICAN FACTORS,  
LIMITED

[Seal] /s/ S. M. LOWREY  
Its Treasurer

Sworn to and subscribed before me this 22nd day of December 1938.

[Seal]     /s/ ABRAHAM K. KEKIPI  
Notary Public, First Judicial Circuit, Territory of  
Hawaii.

Reasons for Allowing the Claim of American Factors, Limited, for Refund of Income Tax Paid for the Calendar Year 1932, and Forming a Part of Its Amended Claim for Refund on Form 843.

American Factors, Limited, hereinafter called the "Taxpayer", filed an income tax return in the Office of the Collector of Internal Revenue at Honolulu, Territory of Hawaii, on or before March 15, 1933, for the calendar and taxable year 1932. Said income tax return, hereinafter called the "Return", showed that no amount was due and payable by said taxpayer on account of income taxes for income received during the calendar year 1932. A representative of the Commissioner of Internal Revenue made an examination of the said return for the calendar year 1932 during the year 1934, and in and by his report dated September 6, 1934 proposed the disallowance of certain claimed deductions, etc., and asserted that the total income tax liability of said taxpayer for the calendar year 1932 was the sum of \$51,270.97.

On or about March 30, 1935 (within the time granted lawfully to said taxpayer to file such pro-



test), said taxpayer filed with the Internal Revenue Agent in Charge its protest dated March 29, 1935 to the proposal to assess the amount of \$51,270.97, or any amount, as a claimed additional Federal income tax for the calendar year 1932.

By his tentative deficiency letter dated April 14, 1937, symbols IT:E:7-8 GVR, addressed to American Factors, Limited, Honolulu, Territory of Hawaii, the Commissioner of Internal Revenue stated that the taxpayer's net income as corrected for the calendar year 1932 was \$459,684.38, and tentatively determined that taxpayer was subject to an additional income tax in the sum of \$63,206.60 for the calendar year 1932.

On or about May 29, 1937 (within the time granted lawfully to said taxpayer to file a protest to said deficiency letter dated April 14, 1937), said taxpayer filed a protest dated May 28, 1937 to the assessment of any additional tax against the taxpayer as and for an income tax for the calendar year 1932.

By letter dated September 3, 1937, symbols IT:E:7-8 GVR-90D, addressed to American Factors, Limited, Honolulu, Territory of Hawaii, the Commissioner of Internal Revenue stated that the determination of the income tax liability of taxpayer for the taxable year ended December 31, 1932 disclosed a deficiency of \$62,438.82, as shown in the statement attached to said letter. In said statement taxpayer's net income as corrected was stated to be the sum of \$454,100.54.

Thereafter, the amount of \$62,438.82 as and for an income tax for the year 1932 was assessed against taxpayer, and taxpayer received a demand from the Collector of Internal Revenue for the District of Hawaii for payment of the same, together with the additional amount of \$17,815.59 as interest thereon. Said tax and interest totaling \$80,-254.41 was paid to the Collector of Internal Revenue for the District of Hawaii by taxpayer on December 30, 1937.

Thereafter, on April 5, 1938, taxpayer filed a claim for refund of the entire amount of tax and interest paid, together with a statement attached thereto and made a part thereof.

Thereafter, on June 29, 1938, the amount of \$12,-657.68 as and for an additional income tax for the year 1932 was assessed against taxpayer, and taxpayer received a demand from the Collector of Internal Revenue for the District of Hawaii for payment of the same, together with an additional amount of \$4,222.81 as interest thereon. Said tax and interest totaling \$16,880.49 was paid to the Collector of Internal Revenue for the District of Hawaii by taxpayer on October 26, 1938.

Thereafter, on December 2, 1938, the Commissioner of Internal Revenue sent, by registered mail, a notice of disallowance of the said claim for refund filed April 5, 1938.

The whole income tax claimed in said letters dated September 3, 1937 and June 29, 1938, and so assessed and paid by taxpayer, results from (a)

the disallowance as a deduction of Hackfeld Litigation Expenses in the sum of \$568,607.76; (b) the disallowance as a deduction as a bad debt of the sum of \$50,000 loaned to Henry Waterhouse Trust Company, Limited, which the taxpayer determined to be worthless and wrote off its books in the calendar year 1932; and (c) the disallowance as a deduction of the amount of \$4,063.33 as reasonable, additional compensation for services rendered by employees prior to their death as an ordinary and necessary expense of the business of the taxpayer.

Taxpayer contends that the Commissioner erred in disallowing these claimed deductions.

## I.

Taxpayer Is Entitled To a Deduction for the Calendar Year 1932 of All the Hackfeld Litigation Expenses.

The taxpayer incorporates by reference all that portion under the same heading as hereinabove which is included in its statement headed, "Reasons for Allowing the Claim of American Factors, Limited, for Refund of Income Tax Paid for the Calendar Year 1932 and Forming a Part of Its Claim for Refund on Form 843", which is annexed to its claim for refund dated April 5, 1938, which said statement is made a part hereof for all purposes as if fully set forth.

The taxpayer contends that the amount of \$87,992.50, which amount was disallowed in the ninety-day letter dated June 29, 1938, and the tax on which

amount is not included in the said claim for refund of April 5, 1938, which has been rejected, is a proper deduction in computing the net income of the taxpayer for the calendar year 1932.

The Commissioner of Internal Revenue, in the ninety-day letter dated September 3, 1937, states that of the amount paid by taxpayer for Hackfeld Litigation Expenses, only \$87,992.50 accrued during the year 1932, and accordingly allowed only this amount as a deduction for said year. However, in his ninety-day letter dated June 29, 1938, this amount of \$87,992.50 was also disallowed on the ground that it was incurred prior to January 1, 1932. The taxpayer contends that this amount accrued in the year 1932, and, in addition, is deductible for the same reasons as are set forth in its claim for refund dated April 5, 1938.

## II.

Taxpayer Is Entitled To Deduct as a Bad Debt the Amount of \$50,000 Loaned to Henry Waterhouse Trust Company, Limited, and Written Off in 1932.

The taxpayer incorporates by reference all that portion under the same heading as hereinabove which is included in its statement headed, "Reasons for Allowing the Claim of American Factors, Limited, for Refund of Income Tax Paid for the Calendar Year 1932 and Forming a Part of its Claim for Refund on Form 843", which is annexed

to its claim for refund, dated April 5, 1938, which said statement is made a part hereof for all purposes as if fully set forth.

The claim for refund of the tax on this amount has been disallowed.

### III.

Taxpayer Is Entitled to Deduct as an Ordinary and Necessary Expense of Its Business the Amount of \$4,063.33, Paid to the Widows and Minor Children of Deceased Employees.

During the calendar and taxable year 1932, taxpayer paid the following amounts to the widows and children of deceased employees: Mrs. R. C. Walker, \$1200; minor children of John Frank, \$300; minor children of W. Zablan, \$240; Mrs. William Searby, \$1800; Mrs. Luddecke, \$523.33. These amounts were paid as additional compensation for services rendered by employees prior to their death and constituted reasonable additional compensation for the services rendered. This amount was first disallowed as a deduction in the ninety-day letter dated June 29, 1938.

The Commissioner in his deficiency letter held that the amounts paid were gratuities and not deductible as ordinary and necessary business expenses, and cited Law Opinion No. 1040, Cumulative Bulletin No. 3, July-December, 1920, Page 120, in support thereof. This opinion, however, appears to support the contention of the taxpayer, particularly in the following excerpt:



“Even when the pension is granted after the employment has been commenced and without any compulsion, legal or moral, of the employer, it may still fairly be regarded as additional compensation. Employers frequently grant increases of pay to employees who are still in their service without any actual necessity for so doing. Nevertheless, it would be foreign to the ordinary conception of the term ‘gift’ to regard such increases as gifts. The same may be said of pensions, even when voluntarily granted.”

The opinion then goes on to say that it is when pensions are awarded by one to whom no services have been rendered and who has received no direct benefit from the services rendered, that such pensions cannot be regarded as additional compensation.

Article 129, Regulations 77, of the Revenue Act of 1932, provides that:

“When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs in recognition of the services rendered by the individual, such payments may be deducted.”

The taxpayer has for some time had the policy of making payments to the widows and children of deceased employees. The payments made are voluntary and are determined by its Board of Directors, which considers, in determining the amount of the pension, the requirements of the widow and



children and the length and value of the services of the deceased employee.

Mrs. R. C. Walker is the widow of a former treasurer of the company, and she was awarded a pension of \$100 per month, beginning July 1, 1920, until further action of the Board.

The minor children of John Frank received, during 1932, \$25.00 per month. John Frank had been in the service of the company for twenty-six years prior to his death and was the head packer at the time of his death, and died leaving a widow and five children.

The minor children of W. Zablan received \$20.00 per month during 1932. Joseph K. Zablan was in the employ of the taxpayer for thirty years and at the time of his death was foreman of the coffee packing room.

Mrs. Searby received the payment of \$150 per month during 1932 and was the widow of a former vice-president of the taxpayer.

Mrs. Luddecke is the widow of an ex-watchman, who was employed for twenty-four years by the taxpayer, and she received a pension of \$10.00 per week during 1932.

The company for some time has made it a practice to provide for some payment to the widow and children of its employees upon their death. This policy is well-known to its employees, and it may reasonably be assumed that employees consider such payments as an additional reward for their faithful service to the company. Such payments

constitute reasonable additional compensation for services rendered by employees and are a necessary and ordinary business expense and deductible as such.

### Conclusion

It is respectfully submitted that the claim of the taxpayer should be allowed.

[Endorsed]: Filed January 6, 1940.

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[Title of District Court and Cause.]

### ANSWER

Defendant for his answer to the Complaint herein, by Ingram M. Stainback, United States Attorney for the District of Hawaii, his attorney, respectfully alleges and shows:

1. Denies each and every allegation contained in paragraph 1 of the Complaint, except he admits that American Factors, Limited, is a corporation incorporated under the laws of the Territory of Hawaii, having its principal office in the Territory of Hawaii, City and County of Honolulu, and that Defendant, at all times since August 1, 1933, has been, and still is, Collector of Internal Revenue for the District of Hawaii.

2. The Defendant is without knowledge or information sufficient to form a belief as to the truth of each and every allegation contained in paragraphs 2, 3, 4, 5, 6 and 7.

3. Denies each and every allegation contained in paragraphs 10, 12 and 13 of the Complaint.

4. The Defendant is without knowledge or information sufficient to form a belief as to the truth of each and every allegation contained in paragraph 8 of the Complaint, except he admits that judgment in favor of the Hackfeld defendants was entered on January 31, 1927.

5. The Defendant is without knowledge or information sufficient to form a belief as to the truth of each and every allegation contained in paragraph 9, except he admits that, on April 30, 1931, the California Supreme Court rendered its opinion affirming the judgment of the trial court and that, on January 29, 1932, the Supreme Court of the State of California rendered an opinion holding that the remittur was not to be recalled.

6. The Defendant is without knowledge or information sufficient to form a belief as to the truth of each and every allegation contained in paragraph 11 of the Complaint, except he admits that, in the so-called Hackfeld litigation, the Plaintiffs were wholly unsuccessful and the Defendants were wholly successful.

7. Denies each and every allegation contained in paragraph 14 of the Complaint, except he admits that on or about February 21, 1931, Plaintiff paid or contributed to the Henry Waterhouse Trust Company, Limited, the sum of \$50,000, and received from that corporation a note.

8. Denies each and every allegation contained in paragraph 15 of the Complaint, except he admits that during the calendar year 1932 Plaintiff paid the total sum of \$4,063.33 to widows and children of deceased employees.

9. Denies each and every allegation contained in paragraph 27 of the Complaint, except he admits that no part of the sum of \$97,134.90 has been paid to Plaintiff.

Wherefore, Defendant demands judgment against the Plaintiff dismissing the Complaint with costs.

Dated: Honolulu, T.H., this 14th day of May, 1940.

/s/ INGRAM M. STAINBACK,  
United States Attorney,  
District of Hawaii.

The receipt of a copy of the within and foregoing Answer is hereby acknowledged this the 14th day of May, 1940.

/s/ U. E. WILD.

Of Counsel:

SMITH, WILD, BEEBE & CADES.

[Endorsed]: Filed May 14, 1940.

[Title of District Court and Cause.]

MOTION TO SUBSTITUTE EXECUTRIX AS  
DEFENDANT WITH CONSENT OF EXEC-  
UTRIX

In the above entitled cause, plaintiff shows that Fred H. Kanne, the above named defendant died on December 24, 1946, and that the Estate of said defendant has passed into the control of Agnes M. Kanne, as Executrix under the Will of said Fred H. Kanne, Deceased, said Agnes M. Kanne having qualified and been confirmed as such Executrix on February 4, 1947, as shown by the records of the Probate Court for the City and County of Honolulu, in the Territory of Hawaii.

Wherefore, plaintiff moves for an order substituting as party defendant herein, Agnes M. Kanne, Executrix as aforesaid, and that otherwise the record in the case may stand as now made and the case proceed on the pleadings and records heretofore filed in said cause.

Dated: Honolulu, T.H., this 3rd day of March, 1947.

SMITH, WILD, BEEBE &  
CADES,

By /s/ U. E. WILD,

Attorneys for Plaintiff.

It is agreed on behalf of the Estate of Fred H. Kanne, Deceased, that the above motion may be

granted and the substitution made as therein requested.

Dated: Honolulu, T.H. this 5th day of March, 1947.

/s/ RAY J. O'BRIEN,

Attorney for Agnes M. Kanne, Executrix under the Will and of the Estate of Fred H. Kanne, Deceased.

Allowed: March 6, 1947.

/s/ J. F. McLAUGHLIN,

U.S. District Judge.

#### Memorandum of Authorities

Sec. 58.74, Merten's Law of Federal Income Taxation, Vol. 10, pages 388, 390:

"Sec. 58.74. Suits Against Collectors. An action of assumpsit may be maintained against the collector of internal revenue who has actually collected an income tax. Such an action is personal in nature and therefore it does not abate when the collector's term expires, or upon his death. If the action against the collector has been commenced, his personal representative may be substituted as the defendant. A collector is liable to suit for taxes wrongfully collected even after his resignation or the expiration of his term. An action to recover taxes erroneously collected will not lie against the successor in office of the collector who collected the tax."



(See also cases cited on page 390; footnotes 80 and 81.)

Smietanka v. Indiana Steel Co.,  
257 U. S. 1, 66 L. Ed. 99, 42 S.Ct. 1

Page 5: "In Patton v. Brady, 184 U. S. 608, 46 L.Ed. 713, 22 S.Ct. Rep. 493, a suit against a collector, begun after the passage of this statute, it was held that it could be revived against his executrix, which shows again that the action is personal; as also does the fact that the collector may be held liable for interest."

[Endorsed]: Filed March 6, 1947.

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[Title of District Court and Cause.]

**MOTION TO AMEND ANSWER TO CONFORM  
TO THE EVIDENCE AND POINTS AND  
AUTHORITIES**

To The Honorable, the Presiding Judge of the  
United States District Court for the Territory  
of Hawaii:

Comes now the Defendant and pursuant to Rules 12(h) and 15(b) of the Rules of Civil Procedure moves this Court for leave to amend the Defendant's answer to the complaint herein with respect to the issues hereinafter set forth which issues are now alleged by the Plaintiff herein not to have been raised or denied by the Defendant's original answer to the allegations contained in paragraphs num-

bered XXIII and XXVI of the complaint, to read as follows:

10. The Defendant denies each and every allegation contained in paragraphs numbered XXIII and XXVI of the Complaint and each and every allegation contained in Exhibits "A" and "B" annexed to the Complaint and referred to therein.

11. The Defendant denies each and every allegation contained in the Complaint not hereinbefore specifically admitted or denied.

This motion is based upon the pleadings, the stipulations of facts, and the testimony and documentary evidence adduced at the trial of this action by the parties hereto.

Dated at Honolulu, T.H., this 15th day of November, 1947.

AGNES M. KANNE,

Executrix under the will and of the estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, Defendant.

By /s/ LELAND T. ATHERTON,  
Special Assistant to the  
Attorney General.

Of Counsel:

By /s/ RAY J. O'BRIEN,  
United States Attorney,  
District of Hawaii.

By /s/ EDWARD A. TOWSE,  
Assistant U. S. Attorney.

In the District Court of the United States for the  
Territory of Hawaii

Civil No. 419

AMERICAN FACTORS, LIMITED, an Hawaiian  
corporation,

Plaintiff,

vs.

AGNES M. KANNE, Executrix under the will and  
of the estate of Fred H. Kanne, Collector of  
Internal Revenue of the United States for the  
District of Hawaii,

Defendant.

### POINTS AND AUTHORITIES

The applicable rules of Civil Procedure permitting the defendant to amend her answer are Rules 12(h) and 15(b):

12. “(h) Waiver of Defenses. A party waives all defenses and objections which he does not present either by motion as hereinbefore provided or, if he has made no motion, in his answer or reply, except (1) that the defense of failure to state a claim upon which relief can be granted, and the objection of failure to state a legal defense to a claim may also be made by a later pleading, if one is permitted, or by motion for judgment on the pleadings or at the trial on the merits, . . . The objection or defense, if made at the trial, shall then be disposed of as provided in Rule 15 (b) in the light of any evidence that may have been received.”

15. “(b) Amendments to Conform to the Evidence. When issues not raised by the pleadings are tried by express or implied consent of the parties, they shall be treated in all respects as if they had been raised in the pleadings. Such amendment of the pleadings as may be necessary to cause them to conform to the evidence and to raise these issues may be made upon motion of any party at any time, even after judgment; but failure so to amend does not affect the result of the trial of these issues. If evidence is objected to at the trial on the ground that it is not within the issues made by the pleadings, the court may allow the pleadings to be amended and shall do so freely when the presentation of the merits of the action will be subserved thereby and the objecting party fails to satisfy the court that the admission of such evidence would prejudice him in maintaining his action or defense upon the merits. . . .”

Rule 15 enables the case to be litigated on the merits. It permits this by the two methods provided therein. Under subdivision (b) if objection is made to the trial of an issue not raised by the pleadings, an amendment is allowable to raise the issue unless the objecting party shows that it will be actually prejudiced, and even if he makes such a showing (which the plaintiff has not done here) the Court may permit the amendment and grant a continuance so that the objecting party may meet the new issue and thus avoid the prejudice which he would suffer if obliged to litigate the issue at that time. But here, there has been no surprise and

over a period of years in conferences with representatives of the Government and in correspondence with the Government plaintiff failed to make any issue concerning the failure of the defendant in her answer to specifically deny the allegations contained in paragraphs numbered XXIII and XXVI of the Complaint and Exhibits "A" and "B" referred to therein. It is now untimely in the face of defendant's motion to amend its answer to conform to the evidence adduced at the trial with respect to the alleged material allegations of fact contained in the taxpayer's claim for refund of the taxes sought to be recovered in these proceedings.

Scott v. Baltimore & O. R. Co.,

1 F. (2d) 61, 64, (fn. 9);

Rogers v. Union Pac. Ry. Co.,

145 F. (2d) 119, 123 (C.C.A. 9);

Wall v. Brim,

145 F. (2d) 492, 493 (C.C.A. 5);

Advance Aluminum Casting Corp. v. Harri-

son, 158 F. (2d) 922, 924 (C.C.A. 7);

Lientz v. Wheeler,

113 F. (2d) 767, 769 (C.C.A. 8);

Mishawaka Rubber & W. Mfg. Co. v. Payne  
& Williams Co.,

139 F. (2d) 603, 606 (C.C.A. 6);

United States v. Cushman,

136 F. (2d) 815, 817 (C.C.A. 9).

By entering into the stipulations of fact, offering them in evidence, and adducing other evidence of the alleged material facts stated in the taxpayer's claims for refund, we submit that any issues not raised by the pleadings with respect to such allegations (if properly deemed to have been made a part of the Complaint herein for all purposes within the terms of Rule 10 (c) of the Rules of Civil Procedure) plaintiff should be deemed to have treated the defendant's answer in all respects as if it had contained a specific denial of said allegations, thus bringing it within the provisions of Rule 15 (b).

Dated at Honolulu, T.H., this 15th day of November, 1947.

Respectfully submitted,  
AGNES M. KANNE,

Executrix under the will and of the estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, Defendant.

By /s/ LELAND T. ATHERTON,  
Special Assistant to the  
Attorney General.

Of Counsel:

By /s/ RAY J. O'BRIEN,  
United States Attorney,  
District of Hawaii.

By /s/ EDWARD A. TOWSE,  
Assistant U. S. Attorney.

[Endorsed]: Filed November 17, 1947.



In the United States District Court  
for the Territory of Hawaii

Civil No. 419

AMERICAN FACTORS, LIMITED, an Hawaiian  
corporation,

Plaintiff,

vs.

AGNES M. KANNE, Executrix under the Will of  
FRED H. KANNE, deceased,

Defendant,

and—Civil No. 474

ALEXANDER & BALDWIN, LIMITED, an Ha-  
waiian corporation,

Plaintiff,

vs.

AGNES M. KANNE, Executrix under the Will of  
FRED H. KANNE, deceased,

Defendant.

## OPINION OF THE COURT

These two cases for the recovery of income taxes paid to the United States Internal Revenue Collector, were both tried in the same hearing.

The claim of American Factors, Limited was for recovery of taxes paid on sums deducted as exemptions from its 1932 gross income tax return, which exemptions were denied by the Collector, as follows:

(1) In 1924 the corporation, together with 23 of

its stockholders, was sued by J. C. Isenberg, et al., for \$10,000,000 damages, alleging fraud in connection with the transfer of the property of Hackfeld & Company, Limited by the Alien Property Custodian to the taxpayer, a newly formed corporation.

Twenty-two of the stockholders who were jointly sued with the taxpayer entered into an agreement among themselves to pay pro rata, on the basis of the stock for which they severally originally subscribed, the litigation costs of this suit. The taxpayer advanced from time to time such costs and expenses as they accrued and rendered accounts to this group of defendant stockholders. This litigation ran for several years and its total cost was \$568,607.76. Of this sum, the twenty-two contributing stockholding defendants paid in to the company the sum of \$396,812.50. There were 615 other original stockholders who were not made defendants who paid nothing into the litigation fund.

When the litigation came to an end in 1932 the taxpayer, being authorized at a meeting of its stockholders, refunded to the twenty-two stockholding defendants the sums they had contributed and deducted the same from its gross income tax return as an item of litigation expense, claiming it was legally liable to these contributors notwithstanding that they had made no claim or demand. This exemption claim is disallowed.

(2) In 1931 this taxpayer advanced the sum of \$50,000 to H. Waterhouse Trust Company, Ltd. in the hope of aiding, with the help of others, the

trust company from closing its doors due to its insolvent condition, which insolvency was known to the taxpayer. The following year the loan was written off the taxpayer's books as a total loss and deducted as a bad debt in its gross income tax return for that year. It claimed that the loan, while somewhat speculative, was made in good faith and supported by a promissory note. The note contained a proviso, as follows:

“Payment of principal and interest to be made only when, if and to the extent that there shall be funds available therefor as set forth in letter of this date from the payor to the payee.”

This deduction claim is disallowed.

(3) In its tax return for 1932 the taxpayer deducted as an ordinary and business expense the sum of \$4,063.33 paid by it as pensions to widows and children of deceased employees. The collector denied this deduction; the Court finds it justifiable and allowed it.

#### *Alexander & Baldwin, Limited's Case.*

The claim of Alexander & Baldwin, Limited was for “bad debt” deduction which had been disallowed, and for a contribution which was also disallowed by the Collector.

In 1931 this taxpayer loaned \$50,000 to Henry Waterhouse Trust Company, Limited for the purposes of reorganization, for which it received a note in the same terms as that received by American Factors. The following year this taxpayer deter-

mined the debt to be worthless and wrote it off in its books as a loss, which loss it claimed in its following tax return. This claim was on the same basis as the American Factor's claim and was disallowed by the Court.

In 1932 this taxpayer contributed \$1,000 to the Hawaiian Bureau of Government Research, an organization maintained by contributions, which was created to gather statistical information and report on public affairs, legislation, social and economic which affected or might affect taxpayers, which contribution was disallowed by the collector.

At the close of arguments November 15, 1947 in the trial of the two cases the Court announced from the bench the following decisions:

“American Factors, Limited.

1. Hackfeld Litigation:

“My opinion is that the persons who subscribed to pay voluntarily for the defense of this inordinately costly litigation were impulsed and motivated entirely by keen personal interests and desires to defeat the demands of the plaintiffs in the case and clear themselves as defendants against claims that they had unlawfully conspired and acted in fraud and agreed, as well as to escape a liability in damages by a possible judgment against them, and to protect their individual investments as shareholders in the corporation, and that they were willing, and made a definite offer to pay, and did pay, to the extent of assessments made against them, without

promise or original expectation of reimbursement at the time and times they made their contributions to the litigation fund.

“There is no evidence that the taxpayer promised or implied an intention to reimburse them at the time they subscribed the agreement or made their contributions, and no evidence that the taxpayer even considered the matter until the backbone of the litigation was broken in victory to all the defendants.

“There was no demand by them or test of their right to have contribution at the expense of other shareholders who were not named as parties defendant. The approval at a stockholders’ meeting and the act of the management in reimbursing these contributors from the company’s funds apparently flowed largely from feelings of gratitude arising from the successful outcome of the case in litigation and the liberal aid of the contributors and their steering committee which contributed many facilities and influences such as could not have been supplied by the management of American Factors acting alone.

“Certainly, the taxpayer had very substantial interests to protect, and was justified in every way, as a legitimate business outlay, in paying from its own funds during the taxable year of 1932, or earlier years had it chosen to do so, the costs of litigation which imperiled its existence although others were involved in the same litigation as defendants and had much to lose, had the others not come for-



ward with funds and volunteered to engineer and fight the battle at their own costs and had the taxpayer not accepted this offered payment plan and the volunteered services; either of the parties could have abandoned or modified this plan at any time, but so long as it was adhered to it was binding on both; but the taxpayer was not justified, in the realm of taxation laws and deductibles, to later deduct from taxable income the money it paid to reimburse voluntary contributors for money which they had paid out to clear themselves and this company of fraudulent charges made against them collectively and individually and to protect their property interests, no matter if victory in such defense brought great benefit to the taxpayer as well as to the other named defendants.

“As between share owners, of course, within ultra vires limitations, they were empowered to make any desired distribution of the company’s funds so long as none was injured.

“The taxpayer is entitled to an expense-deduction in its 1932 tax return of the sum of all Hackfeld litigation paid by it prior to the end of 1932, less the amount paid in to it for that purpose by the other defendants. The claim for tax refund on sums reimbursed to voluntary contributors to this litigation fund is denied.

2. “As to the Waterhouse Trust Company contribution of \$50,000, that was just that—a contribution. The note given in acknowledgement of the contribution was contingent as to value upon such



conditions as to give it no negotiable value from the time it was made. It could not be dealt with as a debt. The considerations in payment for the contribution flowed to the payee of the note at the time it was made—the protection of the commercial community, sympathy toward Waterhouse Company clients who could ill afford to lose, and other commendable desires and motives of helpfulness and security, but there was no attempt to show that either American Factors or Alexander & Baldwin would have suffered any material loss had they not attempted to keep the Waterhouse Trust Company a going concern.

“I find that no part of this contribution was deductible as a bad debt or loss in 1932 or at any other time, since it never was a collectible debt, but was from the beginning in the nature of a contingent or speculative gift, to which status it speedily resolved itself with certainty, although it may have accomplished in part the purpose for which it was intended, that is, prolonged the life of Waterhouse Trust Company. Claim for tax refund on this outgoing sum of \$50,000 is denied.

3. “As to the items of contributions or pensions to dependents of deceased employees, I am fully convinced from the evidence that this was a usual and, within ordinary business discretion, a necessary and proper business practice. It is well recognized that it would reasonably tend to the gratification, good will and loyalty of employees in general and

thus be a benefit to business operations, particularly in a business under many department heads and of ramified operations.

“I find these moderate and reasonable items to be proper income tax deductions.

“Alexander & Baldwin, Limited.

1. “My opinion and finding with respect to the Waterhouse Trust contribution in the American Factors case is, in all pertinent respects, applicable to the refund claim of this litigant and the said claim is denied.

2. “As to the contribution to maintain the Hawaiian Bureau of Government Research, I find this to be an ordinary and necessary expense to a firm carrying on the business and business trusts and responsibilities such as Alexander & Baldwin carry.

“If more extensive findings and conclusions are desired, the prevailing parties may prepare and submit such proposals to me, after tendering copies to opposing counsel.”

/s/ D. E. METZGER,  
Judge.

[Endorsed]: Filed March 18, 1948.

[Title of District Court and Cause.]

FINDINGS OF FACT  
AND CONCLUSIONS OF LAW

1.

Findings of Fact

Upon the record, testimony and evidence adduced in this case, the Court makes the following findings of fact:

I.

That American Factors, Limited, plaintiff herein, is a corporation organized under the laws of the Territory of Hawaii, with its principal office in Honolulu, City and County of Honolulu, Territory of Hawaii; that at the end of that calendar year and during the entire calendar year 1931 it was agent for thirteen sugar plantations and other corporations located in and carrying on business in the Territory of Hawaii and elsewhere, which corporations, according to their books and annual reports, had a total capital of \$26,944,720.00 and a total surplus and undivided profits of \$21,411,420.24, or a total capital and surplus as of December 31, 1930, of \$48,356,140.24; and that on December 30, 1930, plaintiff and the companies for which it served as agent had on deposit in banks in the Territory of Hawaii at least a total sum of \$1,741,696.24.

II.

That Fred H. Kanne was Collector of Internal Revenue of the United States of America for the District of Hawaii and a resident of Honolulu at

all times from on or about August 1, 1933, until his death on December 24, 1946; that Agnes M. Kanne, the duly qualified and appointed Executrix of the Will and of the Estate of Fred H. Kanne, deceased, was substituted as defendant in this cause by order of this Court on March 6, 1947.

### III.

That when the United States of America entered the First World War, H. Hackfeld and Company, Ltd., was an Hawaiian corporation which was then conducting and had conducted prior thereto a sugar plantation agency, general merchandise stores, and other businesses and was a large factor in the Hawaiian sugar industry and in other businesses in the Territory of Hawaii; that it had been and was at that time controlled by German interests; that on or about January 28, 1918, and during March 1918, the Alien Property Custodian of the United States of America seized the capital stock of said Hackfeld Company, owned by German Nationals and thereby gained control either directly or indirectly of approximately 68½% of its capital stock.

### IV.

That prior to January 28, 1918, the business of said Hackfeld Company had been seriously disrupted as a consequence of restrictions placed upon it by the allied governments as a result of its German affiliations and those of its stockholders; that a plan for the reorganization of the company was

formulated in the office of the Alien Property Custodian of the United States of America which contemplated the placing of the ownership and control of the assets and businesses of said Hackfeld and Company, Ltd., wholly in the hands of loyal American citizens, and as a result of which plan the American Factors, Limited, the plaintiff herein, was organized for the express purpose of taking over the business and assets of said H. Hackfeld and Company, Limited, as a going concern, and that as an integral part of said plan the entire capital stock or trust certificates therefor of American Factors, Limited, was to be sold, and was sold, to American citizens familiar with the sugar agency business in the Hawaiian Islands who could properly and efficiently manage its business, and in whom the subscribing public would have confidence; and that to that end it was the desire of the Alien Property Custodian and his plan that a large portion of the trust certificates should be purchased by persons and corporations who were then engaged in the plantation agency business in Hawaii.

## V.

That pursuant to the aforesaid plan, trust certificates representing fifty thousand shares of the capital stock of plaintiff were issued and sold for the price of \$150.00 a share and a total stated consideration of \$7,500,000.00 was duly paid in cash or United States liberty bonds at par to said Hackfeld Company, and in exchange therefor Hackfeld Company



conveyed all of its assets and businesses as a going concern on August 20, 1918, to plaintiff, and plaintiff assumed all liabilities of Hackfeld Company, Limited, and of the business and thereafter continued the business as a going concern.

## VI.

That among the subscribers who participated in a joint subscription agreement for trust certificates for twenty-seven thousand shares of stock of the plaintiff corporation were persons who were incorporators of plaintiff and persons who subsequently became its officers and directors and otherwise participated in the business and affairs of plaintiff, to whom an allotment of trust certificates for twenty-five thousand shares of plaintiff was made; that the remaining trust certificates for twenty-five thousand shares of plaintiff's stock were sold to approximately 614 other persons and corporations who did not join in the subscription agreement.

## VII.

That in June 1924 the then directors of plaintiff were informed that certain former stockholders of Hackfeld Company, Limited, then dissolved, threatened to initiate litigation, but at that time it was not known what form such litigation would take nor who would be the defendants; that the board of directors of plaintiff authorized its president to secure counsel for it, to prepare for and conduct the defense of plaintiff in the threatened litigation if



plaintiff were named a defendant therein, and plaintiff procured the services of attorneys to represent it in the litigation.

### VIII.

That prior to the filing of the suits in the threatened litigation, twenty-one of the twenty-three persons and corporations who had joined in the joint subscription agreement for shares of plaintiff entered into a written agreement on July 28, 1924, to which plaintiff was not a party, wherein they agreed to prorate on an original per share basis the expenses of the threatened litigation if they were joined as defendants therein; that two of the individuals who had joined in the joint subscription agreement for shares of the plaintiff did not participate in the agreement for sharing the expenses of the threatened litigation because they had died.

### IX.

That in August and September 1924, identical actions were instituted by J. C. Isenberg et al, plaintiffs, complainants, against George Sherman and American Factors, Ltd., et al, defendants, respondents, in the Circuit Court of the First Judicial Circuit, Territory of Hawaii, and in the Superior Court of the State of California in and for the City and County of San Francisco; that the suit filed in the California court was the only suit actually tried; that American Factors, Limited, was one of the defendants named in both of said suits and the twenty-three corporations and persons, including the rep-

representatives of the two deceased persons who had joined in the joint subscriptions agreement for the shares of plaintiff, were joined as defendants; and the Alien Property Custodian of the United States was also made a respondent but no relief or judgment was sought against him.

## X.

That the complaint in the aforesaid action which was begun in the Superior Court of the State of California was entitled "Complaint for Accounting, Relief against Fraud and Conspiracy, for Damages and Incidental Relief"; that it affirmed the sale and transfer of the assets of H. Hackfeld and Company, Limited, and alleged "that the sale and transfer [of said assets and businesses] were the result of conspiracy, collusion and fraudulent connivance on the part of certain of the defendants whereby they caused to be sold to American Factors, Ltd. (the taxpayer herein) at a price far below its alleged intrinsic value, in fraud of and to the financial injury of plaintiffs"; that it alleged that the property so transferred was worth \$17,500,000.00 and claimed \$10,000,000.00 damages, and in addition claimed damages in the amount of \$2,500,000.00 against American Factors, Limited, for alleged mismanagement of the business and the assets; that the complaint in said action in substance alleged that American Factors, Limited, took and received all of the assets of H. Hackfeld & Company, Limited, with full knowledge of all of the facts and circumstances set forth in the complaint and with full knowledge of and concerning the rights and equities

of the stockholders of said H. Hackfeld & Company, Limited, and did thereafter handle the said assets and conduct said business in trust for the protection by it of the rights and equities of said stockholders and the complainants; that American Factors did so manage said business and did so improperly handle said assets as to cause great damage to said assets and business and great injury to the rights and equities of said stockholders and complainants; that American Factors was a party to the fraudulent scheme and the conspiracy therein alleged and holds said business and said property in trust to protect the rights and equities of complainants; and that by its mismanagement of said business and said assets, it has caused further and additional losses to said business and to said stockholders of said Hackfeld Company; that among the prayers in the complaint in said action it was prayed that the California court enter its order directing American Factors, Limited, to hold that part and portion of the assets and business belonging to it and representing the interest in said corporation of the respondents in trust for the complainants, subject to the application of said assets to the satisfaction of such judgment as may be entered therein against said respondents, and that it hold all of its said assets subject to their application and such judgment as may be rendered against it; that the California court also enter an order directing the respondents other than American Factors, Limited, to hold their stock in American Factors, Limited,

in trust therein, subject to the application of said stock to the payment of such judgment as may be entered therein against said respondents; that the Court make and enter its judgment against all the respondents, including American Factors, Limited, in such manner as to the Court may seem just and proper and for such an amount as will adequately and completely compensate and reimburse the complainants for the injury, loss and damage suffered by reason of the fraud perpetrated by the respondents; and that the Court do make and enter its judgment against American Factors, Limited for such an amount as it may appear that complainants have been injured by reason of injury to their equity and rights attaching to the property of the corporation through mismanagement and breach of fiduciary duty committed by American Factors, Limited.

## XI.

That the attorneys employed by American Factors, Limited, after investigating the facts and matters pertaining to the Hackfeld litigation, prepared a joint answer on behalf of American Factors, Limited, and the other Hackfeld defendants except the Alien Property Custodian and other nominal defendants, and signed and filed their answer on behalf of American Factors, Limited, and the other twenty-three co-defendants named in the Hackfeld suits. A separate answer was filed on behalf of the Alien Property Custodian.

## XII.

That on January 6, 1926, the trial judge of the Superior Court of California filed the following memorandum:

“I am of the opinion that (1) no actual fraud on the part of respondents was shown; (2) no constructive fraud existed; (3) the price paid was adequate; (4) the suit is not barred by the Hawaiian statute of limitations; (5) plaintiffs were not guilty of laches. Frank J. Murasky, Judge.”

This memorandum is reported in the case of *Isenberg v. Sherman*, 212 Cal. 454, 461; 298 Pac. 1004. On March 16, 1926, a decision comprising Findings of Fact and Conclusions of Law was filed by the same trial judge, and on January 31, 1927, judgment was entered for the defendants and against the complainants.

## XIII.

That an appeal was perfected by the plaintiffs in the aforesaid equity suit (the California case) to the Supreme Court of the State of California, where after further hearings and arguments the California Supreme Court on April 30, 1931, rendered its opinion affirming the judgment of the trial court. The opinion of the Supreme Court of California is reported in 212 Cal. 454, 298 Pac. 1004. On May 28, 1931, the Supreme Court of California denied a petition for rehearing, and thereafter a motion to recall the remittitur issued to the County Clerk of San Francisco was filed by the complain-



ants on August 6, 1931, and the Supreme Court of California on January 29, 1932, denied the complainants' motion to recall the remittitur. The decision of the Supreme Court of California on this motion is reported in 214 Cal. 722, 7 Pac. 2d 1006. On April 25, 1932, the Supreme Court of the United States denied a petition filed by the Hackfeld plaintiffs for a writ of certiorari to the Supreme Court of California, 286 U. S. 547. This terminated all litigation between the parties in the aforesaid suit.

That the Superior Court of the State of California in the aforesaid decision filed on March 16, 1926, among others made the following Findings of Fact:

“XL.

\* \* \*

“The 50,000 fully paid shares of stock of American Factors, Ltd., mentioned in said stockholders resolution and subject to all the terms and conditions thereof, were at the time that they were issued to H. Hackfeld & Co., Ltd., in exchange for the property in this finding referred to, an adequate, just and fair price to H. Hackfeld & Co., Ltd., for all and singular the property, business, rights, contracts, agencies, franchises, credits, accounts and other interests of every kind of said H. Hackfeld & Co., Ltd., and the good will thereof as a going concern, subject to its outstanding debts, obligations and liabilities, including income taxes for the year 1918 up to the date of transfer of said property, etc. to said American Factors, Ltd.

\* \* \*



## “XLV.

“The defendants did not, nor did any of them, reap any benefits from said reorganization, or from the sale of said stock of American Factors, Ltd., or the trust certificates therefor, or from the purchase thereof by themselves except such benefits as accrued to every purchaser of said trust certificates.”

## XV.

That American Factors, Limited, from time to time received from its co-defendants in the Hackfeld litigation their pro rata share of the expenses of that litigation and paid all of the expenses of that litigation which totalled \$568,607.76, but American Factors carried these payments as deferred items on its accounting records until after the conclusion of that litigation in 1932, when it charged off in that year on its books the entire amount thereof and took the same as a deduction in computing its taxable net income for that year.

In that year, after the conclusion of the Hackfeld litigation, American Factors, Limited, repaid to its co-defendants \$396,812.50, representing the total of the amounts so received by it from them during the progress of the litigation. Repayment of the \$396,812.50 was authorized by resolution adopted by the board of directors of the plaintiff at a meeting thereof held on March 4, 1932; but the reimbursement to plaintiff's stockholder-co-defendants was wholly voluntary on the part of plaintiff and was not made pursuant to any demand by its said

stockholder-co-defendants, or as a result of a test of their right to have contributions at the expense of other shareholders who were not named as parties defendant in said Hackfeld litigation. There is no evidence that plaintiff promised or implied an intention to reimburse its co-defendants in the Hackfeld litigation at the time they subscribed or made their contributions toward the expense of conducting that litigation, and there is no evidence that plaintiff even considered the matter until the litigation was finally concluded in 1932; and the approval at the stockholders' meeting of plaintiff of the act of its management in reimbursing its stockholder-co-defendants from the company's funds apparently flowed largely from feelings of gratitude arising from the successful outcome of the case in litigation and the liberal aid of the contributors and their steering committee in supplying the many facilities and influences which could not have been supplied by the management of American Factors acting alone.

## XVI.

That the twenty-three co-defendants who subscribed to the agreement among themselves to pay voluntarily for the defense of the Hackfeld litigation were motivated entirely by keen personal desires to defeat the demands of the plaintiffs-complainants in the Hackfeld suits and clear themselves as defendants against claims that they had unlawfully conspired and acted in fraud and greed, as well as to escape a liability in damages by possible judgment against them, and to protect their individual

investments as shareholders in the plaintiff corporation; and they were accordingly willing and did make a definite offer to pay, and did pay to the extent of assessments made against them, without promise or original expectation of reimbursement at the time and times they made their contributions to the litigation defense fund.

### XVII.

That plaintiff had very substantial interests to protect in defending the Hackfeld litigation which imperiled its existence, and had much to lose had the other co-defendants not come forward with funds and volunteered to engineer and fight the battle at their own cost, and had plaintiff not accepted their offered payment plan and their volunteered services. In its federal income tax return for the taxable year 1932, plaintiff took the entire amount of \$568,607.76 of Hackfeld litigation expenses as a deduction in computing its taxable net income, and the Commissioner of Internal Revenue disallowed the entire amount claimed as a deduction.

### XVIII.

That the Henry Waterhouse Trust Company, Limited, was incorporated under the laws of the Territory of Hawaii on November 26, 1902, to engage in the business usual and permitted to a trust company under the laws of the Territory. In addition to engaging in the usual fiduciary business common to all trust companies, it operated a planta-

tion agency department, a real estate department, a stock and bond brokerage department, and an insurance department, and at times invested in stocks and bonds to a limited extent on its own account, these various activities being permissible under the Hawaiian statutes and its Articles of Incorporation.

### XIX.

That in the middle of October, 1930, the Henry Waterhouse Trust Company increased its capital stock from \$200,000.00 to \$400,000.00, consisting of four thousand shares of a par value of \$100.00 each. The new shares were all taken by old stockholders who paid for them in cash at par. In November of that year, the effects of the general business depression began to be felt in the Territory of Hawaii, and as a large part of the Waterhouse Company assets consisted of real estate and mortgages, its secretary became apprehensive that if many calls were made on its demand accounts the company's financial condition would not be sufficiently liquid to meet its cash requirements. He discussed the situation with the treasurer and auditor of the Company and informed the management of Bishop Trust Company, Limited, that a sale of the Waterhouse stock might be arranged, suggesting a price of \$100.00 each or more for the shares, the Bishop Trust Company taking the suggestion under consideration pending an examination of the affairs of the Waterhouse Company.

## XX.

In 1931 the Waterhouse Company was conducting business as usual but was encountering some financial difficulties; economic conditions were not clear, and, after an investigation, the executives of the Bishop Trust Company, Limited, advised the Waterhouse Company shareholders that it would not pay cash for their shares as had been previously suggested. Mr. A. W. T. Bottomley, president of American Factors, Limited, and of the Bishop First National Bank of Honolulu, and vice-president of the Bishop Trust Company, Limited, called a conference of the heads of the principal Hawaiian sugar agencies, the president of the Bank of Hawaii, Limited, the president of the Hawaiian Trust Company, Limited, and two members of the finance committee of the Bishop Trust Company, Limited, to present to them the financial condition of the Waterhouse Company and discuss the feasibility of making some plan to prevent the Waterhouse Company from being forced into liquidation.

## XXI.

That on Saturday, February 14, 1931, Mr. W. F. Frear, President of the Bishop Trust Company, Limited, at a meeting of the Board of Directors of that Company, made a statement which was recorded on the minutes as follows:

“This is a special meeting called to consider a proposition to take over the Henry Waterhouse Trust Co., Ltd. At first it was a proposition to



purchase the stock of that company, somewhat as we purchased the stock of the Pacific Trust Co., but as a result of investigation, it changed largely to a salvage proposition.

“The plan now is for our Company to acquire all the stock of the Waterhouse Trust Company without cost; for Mr. and Mrs. R. W. Shingle and Mr. A. N. Campbell, in settlement of their indebtedness to the Company, to pay into it \$535,000.00 and to convey to its order their respective 18% and 10% undivided interests in certain land, fish ponds and fishery at Kalihi, the same to be sold for \$87,000.00 and the proceeds, with \$13,000.00 additional contributed by the Bishop Trust Co., to make up an even \$100,000.00, to be paid into the Waterhouse Trust Co., making in all \$635,000.00 thus paid in. In addition, a number of corporations and individuals are to contribute various sums aggregating \$400,000.00, thus making altogether \$1,035,000.00 of cash to be paid into the Waterhouse Trust Co. The Bishop Trust Co. is to pay such amount, if any, as may be required in addition to enable the Waterhouse Trust Company to meet its liabilities, but it is hoped that no such contribution will be required. That, however, remains to be seen.

“The Bishop Trust Co. is to take over, without other cost, the business of the Waterhouse Trust Co., other than the assets and liabilities, and to operate such business at its own expense and for its own benefit. This will include the trusts, executorships, agencies, insurance, safe deposit business, etc.,



with the necessary furniture, equipment and supplies therefor. It is hoped also that the Bishop Trust Co., will profit through making new contacts. The stock and bond and real estate departments will probably be discontinued.

“The assets and liabilities of the Waterhouse Trust Co. are to be gradually liquidated by applying the assets to the liabilities, together with the expenses of liquidation, including \$1,000.00 a month to be paid to the Bishop Trust Co. for supervision.

“In final settlement, if there is an excess of assets over liabilities, it is to be applied, first, to the reimbursement of the amount, if any, that may be contributed by the Bishop Trust Co. in addition to the \$1,035,000.00, and, secondly, pro rata to the contributors of the \$400,000.00 with simple interest at 4%, and, thirdly, the balance, if any, to go to the Bishop Trust Co.

“There are three objects: First, to prevent the failure of such a company as the Waterhouse Trust Co., with the consequent general disastrous effects; secondly, to prevent loss on the part of many who have entrusted their money to the Company for investment and who can ill afford the loss; and, thirdly, to enable the Bishop Trust Co. to acquire new business. These three objects naturally appeal with different degrees of force to different groups of contributors.”

The plan, as outlined above, was approved by the Board of Directors of the Bishop Trust Company, Limited, at that meeting; and the transactions men-

tioned in the second paragraph of Mr. Frear's statement were duly performed within a few days after February 14, 1931.

## XXII.

Prior to the consummation of the transactions hereinbefore mentioned, the following individuals and corporations promised to pay to the Waterhouse Company, upon consummation of the proposed plan, the sums of money set opposite their names, to wit:

Name of Contributor	Amount Paid
The Bishop Company, Limited....	\$100,000
American Factors, Limited.....	50,000
Alexander & Baldwin, Limited....	50,000
Castle & Cooke, Limited.....	50,000
W. R. Castle.....	50,000
Beatrice Castle Newcomb.....	50,000
Bank of Hawaii.....	25,000
Hawaiian Trust Company, Limited	25,000
Total.....	<hr/> \$400,000

## XXIII.

That at a meeting of the Board of Directors of American Factors, Limited, held on March 2, 1931, payment of \$50,000.00 to the Waterhouse Company pursuant to the aforesaid plan was duly authorized.

## XXIV.

That the plan of reorganization of the Water-

house Company was carried out as outlined above and plaintiff and the individuals and other corporations whose names appear above in the preceding paragraph, number XXII of these findings, actually paid into the Waterhouse Company the amounts of money stated opposite their respective names, upon the provisions concerning the repayment thereof as are more particularly stated in the letters from the Henry Waterhouse Trust Company to plaintiff dated February 21, 1931, and February 24, 1931, which read respectively as follows:

“We outline as follows the plan in regard to the Henry Waterhouse Trust Company, Limited.

“1. The Bishop Trust Co., Ltd., has acquired all of the capital stock of the Henry Waterhouse Trust Co., Ltd.

“2. In settlement of their indebtedness to the Henry Waterhouse Trust Co., Ltd., R. W. Shingle and wife have paid into that Company \$435,000.00; A. N. Campbell has paid into it \$100,000.00; and R. W. Shingle and A. N. Campbell are to convey to the Company or to its order their respective 18% and 10% undivided interests in certain land, fish ponds and fishery at the near Mokauea, Kalihi-kai, Honolulu, the same to be sold and the proceeds thereof, plus such additional sum (to be contributed by Bishop Trust Co., Ltd.) as shall be necessary to make a total of \$100,000.00, to be paid to the Henry Waterhouse Trust Co., Ltd.

“3. The following corporations and individuals

have contributed or are to contribute the following sums to the Henry Waterhouse Trust Co., Ltd.: The Bishop Co., Ltd., \$100,000.00; American Factors, Ltd., Alexander & Baldwin, Ltd., Castle & Cookè, Ltd., W. R. Castle and Beatrice Castle Newcomb each \$50,000.00; and the Bank of Hawaii, Ltd., and the Hawaiian Trust Co., Ltd., each \$25,000.00. For the amounts of these contributions notes of the Henry Waterhouse Trust Co., Ltd., of even date herewith, bearing simple interest at the rate of four per cent (4%) per annum, have been or will be given to the respective contributors, payable, however, only as provided in paragraph 8.

“4. The Bishop Trust Co., Ltd. will ultimately contribute such amount, if any, over the above sums aggregating \$1,035,000.00, as may be required to liquidate the liabilities (other than the sums or notes mentioned in paragraph 3) of the Henry Waterhouse Trust Co., Ltd.

“5. The Bishop Trust Co., Ltd., will take over, own and operate at its own expense and for its own benefit, in its own name or in the name of the Henry Waterhouse Trust Co., Ltd., the business (with such of the furniture, equipment and supplies as shall be required therefor) other than the assets subject to the liabilities (referred to in paragraph 6) of the Henry Waterhouse Trust Co., Ltd. Any of the business so taken over by the Bishop Trust Co., Ltd., may by it be discontinued, sold or merged with its other business.

“6. The assets and liabilities of the Henry Waterhouse Trust Co., Ltd., will gradually be liquidated by applying the assets or their proceeds and the income therefrom to (a) the expenses involved in such liquidation (such as salaries, taxes, rent, insurance, legal, auditing, bank examiner, postage, cables, books, stationery, etc.); (b) \$1,000.00 per month to the Bishop Trust Co., Ltd., for overhead or supervision; (c) interest payable; (d) indebtedness; and (e) other liabilities, if any. The assets shall be deemed to include cash on hand, bank deposits, notes and accounts receivable, stocks and bonds, stock exchange seat, and furniture, equipment and supplies (except as otherwise provided in paragraph 5) owned by the Henry Waterhouse Trust Company, Ltd., at the close of business on February 14, 1931, and the sums since paid or to be paid in as set forth in paragraphs 2, 3 and 4; the liabilities shall be deemed to include all liabilities of the Company as of that date, and liabilities subsequently incurred in connection with the liquidation; the expenses of operation shall be deemed to include, besides other items, the cost of investigation by accountants preliminary to the reorganization, the cost of an audit of the Company's affairs and of the set-up of the accounting system at the outset by accountants, a proper pro rata of salaries of officers and employees of the Bishop Trust Co., Ltd., transferred temporarily for the reorganization, rehabili-



tation and readjustment of the affairs of the Henry Waterhouse Trust Co., Ltd., at the outset and a proper pro rate of the salaries of officers and employees of the Henry Waterhouse Trust Co., Ltd., so long as their services are rendered in part in connection with the liquidation and in part in connection with the business taken over by the Bishop Trust Co., Ltd. It is proposed, for convenience, efficiency and economy, to transfer the various branches of the business to the Bishop Trust Building as soon as the circumstances warrant.

“7. In final settlement, the excess, if any, of the assets as defined in paragraph 6 or their proceeds and the income therefrom over the payments specified in paragraph 6 is to be applied, so far as it will go, in the following order of priority; First, to reimbursing the Bishop Trust Co., Ltd., for such amount, if any, without interest as may be contributed by it under paragraph 4 above; secondly, to paying pro rata, principal and interest, the notes mentioned in paragraph 3, and thirdly, the balance, if any, of such excess to be paid to the Bishop Trust Co., Ltd.

“8. The Henry Waterhouse Trust Co., Ltd., may from time to time borrow money (from the Bishop Trust Co., Ltd., and/or others) to meet its requirements in connection with the liquidation and repay the same with interest. The notes (principal and interest) mentioned in paragraph 3 shall be payable only if and to the extent that there shall be an excess of assets available therefor in final settlement after



the payments specified in paragraph 6 and the reimbursement of the Bishop Trust Co., Ltd., provided for in subdivision First of paragraph 7. The books of the Henry Waterhouse Trust Co., Ltd., shall be closed at the end of each calendar half year and a financial statement for such half year shall thereupon be furnished to each of the contributors named in paragraph 3. Such contributors shall have the right to inspect the books of the Company at all reasonable times."

"Supplementing our letter of the 21st instant in regard to the Henry Waterhouse Trust Co., Ltd.:

"1. There is a Finance Committee, consisting at present of M. B. Renshaw, J. L. Cockburn and E. W. Sutton, for frequent consultation on numerous matters, including many that naturally it would be impracticable to bring before the Advisory Committee referred to in the next paragraph.

"2. There will be an Advisory Committee for passing upon various matters of importance, particularly those tending to affect the amount of reimbursement, if any, ultimately to be made to the contributors mentioned in paragraph 3 of the letter above referred to—such matters as sales of stocks and bonds owned by the Company, compromises of claims by or against the Company, etc. This Committee will consist for the present of A. W. T. Bottomley, C. H. Cooke and A. L. Castle, with alternates as follows to act in their several respective places when they cannot act: H. A. Walker and

S. M. Lowrey, alternates to A. W. T. Bottomley; R. McCorriston and E. W. Carden, alternates to C. H. Cooke; F. C. Atherton and A. G. Budge, alternates to A. L. Castle.”

Plaintiff received from the Waterhouse Company the following note, being the note referred to in the aforesaid letter dated February 21, 1931:

“(\$50,000.00) February 21, 1931

For value received, the Henry Waterhouse Trust Company, Limited, promises to pay to American Factors, Limited, Fifty Thousand Dollars (\$50,000.00), with interest thereon from date at the rate of four per cent (4%) per annum, payment of principal and interest to be made only when, if and to the extent that there shall be funds available therefor as set forth in letter of this date from the payor to the payee.

HENRY WATERHOUSE  
TRUST COMPANY,  
LIMITED,

By /s/ W. F. FREAR,  
Its President.

[Seal] By /s/ H. A. WHITE,  
Its Treasurer.”

Plaintiff was not a stockholder of the Waterhouse Company.

## XXV.

That as of February 14, 1931, the \$400,000.00 par value of capital stock of the Waterhouse Company was transferred to the Bishop Trust Company,

Limited, without any cash payment therefor, and the cash balances, properties, stocks and bonds, accounts, books and records of the Waterhouse Company came under the management and control of the Bishop Trust Company, Limited, as sole stockholder. New officers and directors were elected, a finance committee comprised of officers and directors, and an advisory committee comprised of representatives of the \$400,000.00 noteholders, were appointed, and work was immediately commenced on the liquidation of the Waterhouse Company.

## XXVI.

That an audit report dated March 31, 1931, of Tennent & Company, certified public accountants of Honolulu, T. H., disclosed the book value of assets of the Waterhouse Company, as of February 14, 1931, to be in the amount of \$4,820,090.92, and the liabilities, exclusive of capital and surplus, to be in the amount of \$4,149,437.06. It was stated in the audit report that the principal purpose of the audit was to establish as accurately as possible the total assets and liabilities as of February 14, 1931, the date control of the company passed to the Bishop Trust Company, and the audit report contained the following statement:

“The Contingent Reserve (for losses) of \$680,-803.15 and the Special Contingent Reserve of \$400,-000.00 referred to above, are considered adequate to cover probably losses in the realization of the assets and liquidation of liabilities.”

The audit report also contained a statement expressing that the Special Contingent Reserve for Losses will remain intact until actual losses written off have fully exhausted that reserve and that additional losses as determined will then be applied pro rata against the Special Contingent Reserve contributions, to wit, the \$400,000.00, representing the amounts paid in by the special noteholders.

In further explanation of Exhibit "A" referred to in paragraph V of stipulation I, particularly with respect to the item of estimated losses amounting to \$1,080,803.15 shown thereon, the auditor who prepared the audit report containing Exhibit "A" hereinbefore described testified as follows:

"A. Exhibit "A", as I see it here, looks to me like it is an exact copy of what was Exhibit "A" in my report, as Government counsel said, so that the figures are identically the same. Now, then, that million and eighty thousand dollars, as it is shown there, is somewhat of a balance figure to make up the million eight hundred fourteen thousand dollars which is the difference of it, or the million and eighty is the difference between the million and eight hundred fourteen thousand and the \$733,000 representing the Shingle and Campbell account. Now, then, the \$1,814,000, according to my work papers, is made up first of the \$1,548,000 about which I just testified, plus approximately \$260,000 more that was added in there to make these figures balance out for two reasons: One being that between the January 31st scheduled preparation and

the February 14, 1931, Shingle and Campbell had paid in the \$635,000 for one thing; also in making up the balance sheet of February 14, we had to take into account that there was an operating—that the company was operating and had gone on from January 1st to February 14th, and during that period the books reflected a loss of \$10,149. Now, then, going back to the million and eighty thousand dollars, that is the figure which when the \$400,000 paid in by the note holders—after that would be paid in and added to the \$680,000 that shows as the net worth on the balance sheet, would make up the million eighty thousand dollars.

\* \* \*

“Q. Mr. Greaney, you mentioned a figure of \$260,000 being added to the estimated losses. Will you explain what that 260,000 odd represented?

“A. The \$260,000 represented a cushion in effect and had the effect of being a cushion to take care of any losses over and above the amount that was put in the loss column on the schedule that was prepared, covering the individual receivables that were on the books.

“Q. And that was done for what purpose?

“A. That was done because by the time we got around to preparing the final report and putting the figures together, the Bishop Trust Company had agreed to take over the operation of the Waterhouse Trust Company and had changed its position somewhat from a position it had taken somewhat shortly prior to that time, that they would pay something



for the stock. And as it finally turned out they refused to pay anything for the stock so that the reserve for contingencies was made to balance up so that it would appear proper to pay nothing for the stock.”

## XXVII.

That the balance sheets of the Henry Waterhouse Trust Company as at February 14, 1931, after the aforesaid reorganization; and at December 31, 1931, and at December 31, 1932, were as follows:

## Henry Waterhouse Trust Company Balance Sheets

Assets:	As at Feb. 14, 1931	As at Dec. 31, 1931	As at Dec. 31, 1932
	After Reorganization		
Cash .....	\$1,044,547.87	\$ 29,700.69	\$ 14,639.50
Investments .....	605,181.47	.....	.....
Receivables .....	77,184.34	.....	15,214.69
Trust and agency accounts (Shingle & Campbell) .....	.....	.....	.....
Other trust & agency accts. ....	1,439,567.36	383,460.67	299,565.32
Loans .....	1,978,492.73	2,247,844.14	1,624,740.12
Other Assets .....	75,117.15	17,434.16	17,326.66
Stocks and bonds .....	.....	251,220.65	267,122.42
Stocks in subsidiaries....	.....	303,704.16	303,704.16
Advances to subsidiaries .....	.....	324,382.60	314,787.92
Real estate for sale.....	.....	169,700.00	233,273.02
Expense in suspense.....	.....	.....	17,500.00
Profit and loss—Special	400,000.00	400,000.00	400,000.00
	<u>\$5,620,090.92</u>	<u>\$4,127,447.07</u>	<u>\$3,507,873.81</u>

Liabilities:

Overdrafts balances due

Brokers, etc. ....	\$ 457,545.90	\$ 79,578.59	\$ 46,648.10
Notes payable .....	223,100.00	376,557.98	674,190.88
Trust & Agency accounts .....	2,978,515.16	1,834,540.86	1,068,907.28
Loans pledged to clients	490,276.00	198,000.00	132,128.00
Merchandise accounts ..	.....	1,252.11	.....
Notes payable— affiliated Co. ....	.....	550,000.00	602,500.00
Income in suspense .....	.....	.....	2,417.13
P. & L. Acct.—operat- ing deficit 2/14/31....	(10,149.29)	(10,149.29)	(10,149.29)
P. & L. Acct.—operat- ing deficit subsequent to 2/14/31 .....	.....	(58,526.56)	(80,062.56)
Surplus & surplus reserves .....	.....	.....	.....
Reserve for losses.....	680,803.15	356,193.38	271,294.27
Contingent reserve— underwriters .....	400,000.00	400,000.00	400,000.00
Capital stock .....	400,000.00	400,000.00	400,000.00
	<hr/>	<hr/>	<hr/>
	\$5,620,090.92	\$4,127,447.07	\$3,507,873.81

At December 31, 1931, Henry Waterhouse Trust Company had sustained on liquidation actual losses amounting to \$324,913.77, and at December 31, 1932, it had sustained on liquidation cumulative actual losses totalling \$410,345.80, so that at the end of 1932 there was still a balance of \$190,457.35 remaining in the Reserve for Losses, against which future losses must be paid before there would be any impairment for the repayment of the \$400,000.00 contributions to the special noteholders.

## XXVIII.

The note given by the Henry Waterhouse Trust Company to American Factors, Limited, in acknowledgment of the contribution of \$50,000 made by that company in 1931 to the Henry Waterhouse Trust Company was contingent as to payment, being subject to such conditions as to render it non-negotiable at the time it was made and at all times thereafter, and without negotiable value from the time it was made. The considerations in payment for the contribution flowed to the payee at the time it was made—the protection of the commercial community, sympathy toward the Henry Waterhouse Trust Company clients who could ill afford to lose, and other commendable desires and motives of helpfulness and security, but there was no attempt to show and there is no evidence of record which would support a finding of fact that American Factors, Limited, would have suffered any loss had it not attempted to keep the Henry Waterhouse Trust Company a going concern.

## XXIX.

Plaintiffs' books of account were kept on the accrual basis of accounting, and, during the calendar year 1924-1932, inclusive, they were so kept, and its Federal Income Tax returns for those years were made on that basis of accounting. In the calendar year 1932, Plaintiff charged off on its books of account the face amount of the aforesaid \$50,000.00 Waterhouse Trust Company note which was given to the plaintiff in the year 1931, pursuant to the

actual method of charging off bad debts which the plaintiff used in that taxable year and all prior taxable years for income tax purposes.

### XXX.

During the calendar year 1932 plaintiff paid the total sum of \$4,063.33 to the following individuals in the amounts stated opposite their names, to wit:

Payee	Amount Paid
Mrs. R. C. Walker.....	\$1,200.00
Minor children of John Frank, deceased.....	300.00
Minor children of W. Zablan, deceased.....	240.00
Mrs. Wm. Searby .....	1,800.00
Mrs. Luddecke .....	523.33
<hr/>	
Total.....	\$2,063.33

The above payments were to widows and minor children of former employees of plaintiff. The above payments were duly authorized and represented a percentage of salaries or other compensation paid to deceased employees who were related to the payees by marriage or otherwise and followed a practice of the plaintiff which had been in effect since 1920 in some instances and which practice these deceased employees and their dependents had a reasonable expectation to believe would be followed in the event of their death.

In its federal income tax return for the taxable year 1932 plaintiff deducted the above amounts as ordinary and necessary expenses in computing its taxable net income. The Commissioner of Internal Revenue in his second deficiency letter disallowed the same.

## XXXI.

That the payment to Mrs. R. C. Walker was in accordance with action taken by the Board of Directors of American Factors at a meeting held on May 18, 1920, at which it was decided to pay Mrs. Walker her deceased husband's salary in full up to June 30, 1920, with a bonus of 25% on the salary for the six months from January 1 to June 30, 1920, and beginning July 1, 1920, and until further action by the Board, she was to be paid a monthly allowance of \$100.00.

## XXXII.

That the payment to the minor children of John Frank, Sr., deceased, was authorized at a meeting of the Board of Directors of American Factors, Limited, held on November 27, 1922, at which meeting it was decided that the pension of \$75.00 a month which had been paid to John Frank while living be continued in favor of his children and the amount of pension was authorized to be increased up to \$100.00 a month to continue until further action by the Board.

## XXXIII.

That the payment to Mrs. Searby was authorized at a meeting of the Board of Directors of American Factors held on November 29, 1929, at which a pension of \$250.00 a month beginning January 1, 1930, and continuing until further action by the Board was authorized.



## XXXIV.

That the payment made for the benefit of the minor children of W. Zablan was paid to the Social Service Bureau for disbursement of the funds from time to time for the benefit of the Zablan minors after an investigation by the Social Service Bureau and pursuant to written instructions given by the manager of the merchandise department and the treasurer of American Factors, Limited, under date of September 17, 1928.

## XXXV.

That the payment made to Mrs. Luddecke was authorized by the manager of the merchandise department and treasurer of American Factors, Limited, on November 26, 1930, after an investigation of Mrs. Luddecke's financial circumstances had been made.

## XXXVI.

That on April 5, 1938, plaintiff filed with the Commissioner of Internal Revenue through the Collector of Internal Revenue a claim for refund of \$80,254.41, which included income tax for the calendar year 1932 in the principal amount of \$62,438.82, and interest thereon in the amount of \$17,815.49, which amount of tax and interest was paid by plaintiff to Collector Fred H. Kanne on December 30, 1937. Said claim was rejected in its entirety by the Commissioner on December 2, 1938.

## XXXVII.

That on December 22, 1938, plaintiff filed with the Commissioner of Internal Revenue through the Collector of Internal Revenue a second claim for refund for the additional amount of \$16,880.49 income tax for the calendar year 1932, paid by plaintiff to Collector Fred H. Kanne on October 26, 1938, which claim was rejected by the Commissioner of Internal Revenue on April 22, 1940.

## XXXVIII.

No amount of the income tax and interest sought to be recovered in this action has been paid or refunded to plaintiff.

## 2.

## Conclusions of Law .

Upon the foregoing facts, testimony and evidence adduced in this case, the Court concludes as a matter of law as follows:

## I.

Plaintiff is entitled to a deduction of \$171,795.26 of the Hackfeld litigation expenses as ordinary and necessary expenses paid or incurred during the taxable year 1932 in carrying on its business, within the terms of Section 23(a) of the Revenue Act of 1932, and accordingly is entitled to a deduction of that amount in computing its taxable net income for the calendar year 1932. The Commissioner of Internal Revenue erred in not treating the said sum of \$171,795.26 as ordinary and necessary expenses incurred

during the taxable year 1932 in carrying on plaintiff's business, and erred in disallowing plaintiff a deduction for that amount of the Hackfeld litigation expenses in computing its taxable net income for the calendar year 1932.

## II.

The sum of \$396,812.50 of the Hackfeld litigation expenses which plaintiff refunded or repaid in the year 1932 to those persons and corporations who were co-defendants with plaintiff in said litigation were not ordinary and necessary expenses paid or incurred during the taxable year 1932 by plaintiff in carrying on its business within the terms of Section 23(a) of the Revenue Act of 1932, and plaintiff is not entitled to a deduction therefor of that amount in computing its taxable net income for the calendar year 1932. The Commissioner of Internal Revenue did not err in disallowing the deduction of \$396,812.50 to plaintiff in computing its taxable net income for the calendar year 1932.

## III.

The plaintiff's stockholders or co-defendants to whom plaintiff repaid in the year 1932 at the conclusion of the Hackfeld litigation the sum of \$396,812.50 of the litigation expenses previously contributed and collected by them could have been abandoned or modified the agreement which had previously been entered into between the said co-defendants, other than plaintiff, to share on a per-

share basis the expenses of said litigation at any time, but so long as their plan and agreement was adhered to, it was binding on all of them and there was no legal obligation or liability on the part of plaintiff to reimburse or refund to its stockholders who were co-defendants with it in the Hackfeld litigation the sum of \$396,812.50 which plaintiff repaid to them in 1932.

#### IV.

As between the stockholders of plaintiff who were co-defendants in the Hackfeld litigation, within ultra vires limitations, they could authorize the repayment to themselves by way of distribution of the company's funds of the sum of \$396,812.50, so long as none was injured, and none of the other stockholders complained. No other stockholder was injured and no other stockholder complained.

#### V.

The payment of \$50,000 made to the Henry Waterhouse Trust Company in 1931 by plaintiff was just a contribution. The note given by the Henry Waterhouse Trust Company in 1931 to plaintiff in acknowledgment of that contribution was contingent as to payment, being subject to such conditions as to render it non-negotiable and without any negotiable value at the time it was made and at all times thereafter, and therefore it could not be dealt with as a debt, and the Commissioner of Internal Revenue did not err in disallowing plaintiff

a deduction therefor as a bad debt in computing plaintiff's taxable net income for the calendar year 1932.

## VI.

No part of this contribution of \$50,000.00 was deductible as a bad debt, ascertained to be worthless and charged off within the taxable year 1932 within the terms of Section 23(j) of the Revenue Act of 1932 or as a loss sustained during that taxable year not compensated for by insurance or otherwise, within the terms of Section 23(f) of the Revenue Act of 1932, and accordingly no part of said contribution was properly allowable as a deduction in computing plaintiff's taxable net income for the calendar year 1932.

## VII.

The aforesaid payments to dependents of deceased employees was a usual, necessary and proper practice, which it is well recognized would tend to the gratification, good will and loyalty of employees in general and thus be a benefit to business operations, particularly in a business under many department heads and of varied ramifications, as was the business of American Factors. The payments made for the benefit of dependents of deceased employees were ordinary and necessary expenses paid or incurred in carrying on plaintiff's business during the taxable year 1932 within the terms of Sec. 23(a) of the Revenue Act of 1932 and did constitute a proper deduction in computing its taxable net in-



come for that taxable year. The Commissioner of Internal Revenue erred in disallowing these payments as a deduction in computing the plaintiff's taxable net income for the calendar year 1932.

Entry of judgment in conformity with the foregoing findings of fact and conclusions of law is hereby directed.

Dated at Honolulu, T. H., this 15th day of June, 1949.

/s/ GILBERT E. METZGER,  
Judge, U. S. District Court.

[Endorsed]: Filed June 15, 1949.

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In the United States District Court for the  
Territory of Hawaii

Civil No. 419

AMERICAN FACTORS, LIMITED, a Hawaiian  
corporation,

Plaintiff,

vs.

AGNES M. KANNE, Executrix under the Will and  
of the Estate of Fred H. Kanne, Collector of  
Internal Revenue of the United States for the  
District of Hawaii,

Defendant.

### JUDGMENT

Be it remembered that on November 12, 1947,  
there came on for trial the above-entitled and num-

bered action wherein this case having been submitted to the Court without a jury upon the pleadings, oral and documentary evidence, and a stipulation of facts, and argument of counsel, and the Court being sufficiently advised, and having made and filed its opinion and findings of fact and conclusions of law herein, now therefore, in pursuance thereto,

The Court having found that the plaintiffs paid income taxes and interest assessed thereon for the taxable year 1932, as follows:

Dates of Payment	Tax	Interest
December 30, 1937 .....	\$62,438.82	\$17,815.59
October 26, 1938 .....	12,657.68	4,222.81
<hr/>		
Total payments .....	75,096.50	22,038.40
Adjusted liability .....	50,915.94	14,527.78
<hr/>		
Overpayments .....	\$24,180.56	\$ 7,510.62

It is hereby ordered, adjudged, and decreed that the plaintiff have and recovered from Agnes M. Kanne, Executrix under the will and of the estate of Fred H. Kanne, deceased, the defendant, formerly Collector of Internal Revenue for the District of Hawaii, the sum of \$31,691.18 representing an overpayment of federal income tax and interest for the taxable year 1932, together with interest thereon as provided by law from the dates of payments, as follows:

On the overpayment of tax in the amount of \$12,657.68, and the overpayment of interest thereon of \$4,222.81 from October 26, 1938; and on the overpayment of tax in the amount of \$11,522.88, and

interest thereon of \$3,287.81 from December 30, 1937, together with the costs of this suit in the amount of \$50.71.

To the foregoing judgment, the defendant in open court excepted.

Entered this 15th day of June, 1949.

/s/ DELBERT E. METZGER,  
U. S. District Judge.

Approved as to Form:

RAY J. O'BRIEN,  
United States Attorney.

By /s/ KENNETH [Illegible],  
Assistant U. S. Attorney.

[Endorsed]: Filed and entered June 15, 1949.

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[Title of District Court and Cause.]

### CERTIFICATE OF PROBABLE CAUSE

This cause having come on for hearing before the Court without a jury, the case having been submitted upon the pleadings, oral and documentary evidence, and a stipulation of facts, and arguments as to the law, and the defendant having appeared herein by the United States Attorney for the District of Hawaii, and the Court having found partially in favor of the plaintiff, and judgment having been entered in favor of the plaintiff and against the defendant in the principal sum of \$31,-691.18 representing an overpayment of federal in-

come tax and interest for the taxable year 1932, together with interest thereon as provided by law from the dates of payment, and costs of suit in the amount of \$50.71,

Now therefore, pursuant to Section 989 of the Revised Statutes of the United States, the Court hereby certifies there was probable and reasonable cause for the act of the defendant, Fred H. Kanne, Collector of Internal Revenue for the District of Hawaii, since deceased, and that he acted under the directions of the Secretary of the Treasury or other proper official of the Government in demanding and collecting from plaintiff the internal revenue tax, for the refund of which the judgment in this case is rendered.

/s/ ROBERT E. METZGER,  
U. S. District Judge.

[Endorsed]: Filed June 15, 1949.

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[Title of District Court and Cause.]

## NOTICE OF APPEAL TO CIRCUIT COURT OF APPEALS UNDER RULE 73(b)

Notice is hereby given that Agnes M. Kanne, Executrix under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, defendant above named, does hereby appeal to the United States Circuit Court of Appeals for the Ninth Cir-

cuit from the final Judgment entered in this action on the 15th day of June, 1949, ordering that the plaintiff have and recover from Agnes M. Kanne, Executrix under the Will and of the Estate of Fred H. Kanne, deceased, the defendant, formerly Collector of Internal Revenue of the United States for the District of Hawaii, the sum of \$31,691.18, together with costs in the amount of \$50.71.

Dated: Honolulu, T. H., this 4th day of August, 1949.

/s/ RAY J. O'BRIEN,

Attorney for Agnes M. Kanne, Executrix Under  
the Will and of the Estate of Fred H. Kanne.

[Endorsed]: Filed August 4, 1949.

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[Title of District Court and Cause.]

## NOTICE OF APPEAL TO UNITED STATES COURT OF APPEALS UNDER RULE 73(b)

Notice is hereby given that American Factors, Limited, an Hawaiian Corporation, plaintiff above named, does hereby appeal to the United States Court of Appeals for the Ninth Circuit from so much of the Final Judgment entered in this action on the 15th day of June, 1949, as orders that the plaintiff have and recover from Agnes M. Kanne, Executrix under the Will and of the Estate of Fred H. Kanne, Deceased, the defendant, formerly Collector of Internal Revenue of the United States



for the District of Hawaii, only the sum of \$31,691.18, together with interest thereon as provided by law and costs of suit in the amount of \$50.71, and denies to said plaintiff the recovery of the full amount of \$97,134.90 with interest and costs as prayed for in the complaint filed herein.

Dated: Honolulu, T.H., this 15th day of August, 1949.

SMITH, WILD, BEEBE &  
CADES.

By URBAN E. WILD and

/s/ MILTON CADES,

Attorneys for American Factors, Limited, Plaintiff.

[Endorsed]: Filed August 15, 1949.

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[Title of District Court and Cause.]

### BOND FOR COSTS ON APPEAL

Know All Men By These Presents:

That American Factors, Limited, an Hawaiian Corporation, as principal, and Hartford Accident and Indemnity Company, a corporation organized under the laws of the State of Connecticut, as surety, are held and firmly bound unto Agnes M. Kanne, Executrix under the Will and of the Estate of Fred H. Kanne, Deceased, formerly Collector of Internal Revenue of the United States for the District of Hawaii, defendant, in the sum of Two Hundred Fifty Dollars (\$250.00) for the payment of

which well and truly to be made, said American Factors, Limited, as principal, and Hartford Accident and Indemnity Company, as surety, do bind themselves, their respective successors and assigns, jointly and severally, and firmly by these presents.

The Condition of This Obligation Is Such That:

Whereas the above bounden principal, American Factors, Limited, has filed its notice of appeal to the United States Court of Appeals for the Ninth Circuit from the decree entered in the above-entitled cause;

Now, Therefore, if the said principal shall prosecute said appeal with effect and answer all costs if it fails to sustain said appeal, then this obligation shall be void, otherwise it shall remain in full force and effect.

Dated: Honolulu, T. H., this 15th day of August, 1949.

AMERICAN FACTORS,  
LIMITED.

By /s/ H. A. WALKER,  
Its President.

[Seal] By /s/ W. T. VORFELD,  
Its Treasurer,  
Principal.

HARTFORD ACCIDENT AND  
INDEMNITY COMPANY.

[Seal] By /s/ JAMES A. MULKERN, JR.,  
Attorney in Fact,  
Surety.

Territory of Hawaii,  
City and County of Honolulu—ss.

On this 15th day of August, A.D. 1949, before me personally appeared James A. Mulkern, Jr., and to me personally known, who, being by me duly sworn did say that he is Attorney in Fact of the Hartford Accident & Indemnity Company, a corporation, of Hartford, Connecticut, duly appointed under Power of Attorney dated the 19th day of September, A.D. 1947, which power of attorney is now in full force and effect, and that the seal affixed to said instrument is the corporate seal of the said corporation and that said instrument was signed and sealed on behalf of said corporation under the authority of the Board of Directors and the said James A. Mulkern, Jr., and acknowledged the said instrument to be the free act and deed of the corporation.

[Seal]        /s/ J. EDITH JORDAN,

Notary Public, First Judicial Circuit, Territory of  
Hawaii.

My commission expires June 30, 1953.

Territory of Hawaii,  
City and County of Honolulu—ss.

On this 15th day of August, 1949, before me appeared H. A. Walker and W. T. Vorfeld, to me personally known, who, being by me duly sworn, did say that they are the President and Treasurer, respectively, of American Factors, Limited, a Ha-

waiian corporation, and that the seal affixed to the foregoing instrument is the corporate seal of said Corporation, and that the instrument was signed and sealed in behalf of said corporation by authority of its Board of Directors, and the said H. A. Walker and W. T. Vorfeld acknowledged said instrument to be the free act and deed of said corporation.

[Seal]        /s/ J. EDITH JORDAN,  
Notary Public, First Judicial Circuit, Territory of  
Hawaii.

My Commission expires June 30, 1953.

[Endorsed]:    Filed August 15, 1949.

[Title of District Court and Cause.]

STIPULATION EXTENDING TIME TO FILE  
TRANSCRIPTS OF RECORD ON APPEALS

It Is Stipulated and Agreed by and between the attorneys for the respective parties herein that the time of defendant-appellant to file a Transcript of Record on Appeal be and the same hereby is extended to and including the 2nd day of November, 1949, and that the time of plaintiff-appellant to file a Transcript of Record on Appeal be and the same hereby is extended to and including the 13th day of November, 1949.

Dated: Honolulu, T. H., September 19, 1949.

/s/ RAY J. O'BRIEN,

U. S. Attorney for the

District of Hawaii,

Attorney for Defendant.

SMITH, WILD, BEEBE &  
CADES.

By /s/ MILTON CADES,

Attorneys for Plaintiff.

So ordered September 20, 1949.

/s/ D. E. METZGER,

U. S. District Judge.

[Endorsed]: Filed September 20, 1949.



[Title of District Court and Cause.]

STIPULATION FURTHER EXTENDING  
TIME FOR FILING RECORD ON APPEAL  
AND DOCKETING APPEAL

Whereas it will not be possible for the court reporter to finish transcribing testimony of certain witnesses by November 2, 1949, the date when the Record on Appeal was to be docketed in the United States Court of Appeals for the Ninth Circuit.

It Is Hereby stipulated and agreed by and between the attorneys for the respective parties herein that both the Plaintiff and the Defendant may have, subject to the approval of the United States Court of Appeals for the Ninth Circuit, to and including the 18th day of November, 1949, within which to file the Record of Appeal and docket the Appeal.

Dated: Honolulu, T. H., this 31st day of October, 1949.

/s/ RAY J. O'BRIEN,

United States Attorney,  
District of Hawaii.

Attorney for Defendant.

SMITH, WILD, BEEBE &  
CADES.

By /s/ MILTON CADES,

Attorneys for Plaintiff.

[Endorsed]: Filed October 31, 1949.

[Title of District Court and Cause.]

DOCKET ENTRIES

1940

Jan. 6—Filing Complaint and Exhibits “A and B”

Issuing Summons

Making 3 certified copies for service

Filing Marshal’s returns to Summons.  
(Executed)

Mar. 5—Filing Stipulation

Mar. 16—Filing Stipulation

Apr. 8—Filing Stipulation

May 14—Filing Answer

June 27—Filing Order

1947

Mar. 6—Filing Motion to Substitute Executrix as  
Defendant with Consent of Executrix

Mar. 7—Filing Memorandum

Nov. 5—Entering order setting case for trial to  
Nov. 12, 1947, at 10 a.m.

Nov. 12—Entering proceedings at trial & contin-  
uance to Nov. 13, 1947, at 10 a.m. for  
further trial

Nov. 13—Entering proceedings at further trial &  
continuance to Nov. 14, 1947, at 9:30 for  
further trial

Nov. 14—Entering proceedings at further trial &  
continuance to Nov. 15, 1947, at 10 a.m.  
for further trial

1947

Nov. 15—Entering proceedings at argument and decision by Court

Filing Transcript of Decision from Bench

Nov. 17—Filing Motion to Amend Answer to Conform to the Evidence and Points and Authorities

1948

Jan 2—Filing Statement of Disapproval of the Form of Defendant's Draft of Findings of Fact and Conclusions of Law

Filing Proposed Additions and Amendments to Defendant's Draft of Findings of Fact and Conclusions of Law

Feb. 11—Filing Defendant's Reply to Plaintiff's Disapproval of the Form of Defendant's Draft of the Findings of Facts & Conclusions of Law

Filing Additions and Amendments to the Draft of Findings of Fact and Conclusions of Law Heretofore Submitted by Defendant

Feb. 16—Filing Objections to Amendments to Defendant's Draft of Conclusions of Law

Mar. 18—Filing Decision

1949

June 15—Filing Findings of Fact and Conclusions of Law

Filing Judgment

1949

Filing Certificate of Probable Cause  
(Judgment—Plaintiff recover the sum of  
\$31,691.18 and int. from deft.—Metzger  
—Judge)

Aug. 4—Filing Notice of Appeal to Circuit Court  
of Appeals under Rule 73(b)

Copy of Notice of Appeal mailed to coun-  
sel for plaintiff

Aug. 15—Filing Notice of Appeal to United States  
Court of Appeals under Rule 73(b)

Copy of Notice of Appeal mailed to coun-  
sel for defendant

Filing Bond for Costs on Appeal

Sept. 20—Filing Stipulation Extending Time to  
File Transcripts of Record on Appeals

Oct. 31—Filing Stipulation as to Designation of  
Record on Appeal

Filing Stipulation Further Extending  
Time for Filing Record on Appeal and  
Docketing Appeal

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[Title of District Court and Cause.]

### CERTIFICATE OF CLERK

United States of America,  
District of Hawaii—ss.

I, Wm. F. Thompson, Jr., Clerk of the United  
States District Court for the District of Hawaii, do  
hereby certify that the foregoing partial record on  
appeal in the above-entitled cause, consists of the

following listed original pleadings of record in said cause:

Complaint, Exhibit "A" and "B"

Answer

Motion to Substitute Executrix as Defendant with Consent of Executrix

Motion to Amend Answer to Conform to the Evidence and Points and Authorities

Decision

Findings of Fact and Conclusions of Law

Judgment

Certificate of Probable Cause

Notice of Appeal to Circuit Court of Appeals under Rule 73(b)

Notice of Appeal to United States Court of Appeals under Rule 73(b)

Bond for Costs on Appeal

Stipulation Extending Time to File Transcripts of Record on Appeals

Stipulation as to Designation of Record on Appeal

Stipulation Further Extending Time for Filing Record on Appeal and Docketing Appeal

I further certify that included in said partial record on appeal is a copy of all docket entries.

In Witness Whereof, I have hereunto set my hand and affixed the seal of said District Court, this 1st day of November, 1949.

[Seal]     /s/ WM. F. THOMPSON, JR.,  
Clerk, United States District Court, District of  
Hawaii.



In the United States District Court for the  
Territory of Hawaii  
Civil No. 419

AMERICAN FACTORS, LIMITED, a Hawaiian  
Corporation,

Plaintiff,

vs.

AGNES M. KANNE, Executrix Under the Will  
and of the Estate of Fred H. Kanne, Collector  
of Internal Revenue of the United States for  
the District of Hawaii,

Defendant.

Civil No. 474

ALEXANDER & BALDWIN, LIMITED,

Plaintiff,

vs.

AGNES M. KANNE, Executrix Under the Will  
and of the Estate of Fred H. Kanne, Collector  
of Internal Revenue of the United States for  
the District of Hawaii,

Defendant.

## TRANSCRIPT OF PROCEEDINGS

In the above-entitled matter, held in the U. S.  
District Court, Honolulu, T. H., on November 12,  
13, 14 & 15, 1947, [1\*]

Before: Hon. Delbert E. Metzger,  
Judge.

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\* Page numbering appearing at top of page of original Reporter's Transcript.

## Appearances:

URBAN E. WILD, ESQ.,

Of the law firm of Smith, Wild, Beebe &  
Cades, appearing for American Factors,  
Limited, Plaintiff;

MILTON CADES, ESQ.,

Of the law firm of Smith, Wild, Beebe &  
Cades, appearing for American Factors,  
Limited, Plaintiff;

DUDLEY C. PRATT, ESQ.,

Of the law firm of Vitousek, Pratt & Winn,  
appearing for Alexander & Baldwin,  
Limited, Plaintiff;

VERNON BORTZ, ESQ.,

Of the law firm of Vitousek, Pratt & Winn,  
appearing for Alexander & Baldwin,  
Limited, Plaintiff;

RAY J. O'BRIEN, ESQ.,

United States Attorney, appearing for the  
Defendant;

EDWARD A. TOWSE, ESQ.,

Assistant United States Attorney, appear-  
ing for the Defendant;

LELAND T. ATHERTON, ESQ.,

Special Assistant to the Attorney General,  
appearing for the Defendant. [2]

The Clerk: Civil No. 419, American Factors,

Limited, Plaintiff, vs. Fred H. Kanne, Collector of Internal Revenue.

Mr. Wild: Ready for the Plaintiff, your Honor.

Mr. Atherton: Ready for the Defendant, your Honor.

Mr. Wild: At this time, may it please the Court, counsel in the Alexander and Baldwin case have asked that the Court hear them make a motion to the effect that the record made and taken in the case now before your Honor concerning the Henry Waterhouse note issue and the loss issue, and so forth, be considered as a part of the record in their case, I think.

Mr. Pratt: Yes, your Honor. The Alexander and Baldwin case, your Honor, is Civil 474, and I believe that counsel for the Government is willing to stipulate at this time that the record on the issue with respect to the Henry Waterhouse Trust Company matter, that is, the record in this American Factors case be considered as part of the record in our case. And my understanding is that the other issues in Civil 419 are to be heard first and that they will be followed by the evidence with respect to the Henry Waterhouse Trust Company transactions. Our case and the American Factors' case in most respects on that issue will be the same.

The Court: What other issues, if any, are involved?

Mr. Pratt: We have one very minor issue which is mentioned [3] in the stipulation which will be submitted to the Court. Most of the facts concern-

ing our case have also been stipulated to, and the stipulation, one, which we will submit, will be identical with the American Factors' stipulation one, except for the facts which are different by reason of its being Alexander and Baldwin, Limited and not American Factors; and the fact that we had one other minor deduction that year with respect to another contribution. Those are covered in a written stipulation. However, on the main issue of Henry Waterhouse Trust Company the facts will be the same, with one other exception, that is, that on our books there is a journal entry of a write-off of \$25,000 in the year 1931, and then the entire \$50,000 which is claimed for tax purposes in 1932, although there was no claim for a tax deduction in '31. There is that distinction between the facts in ours and American Factors' case.

I would like to have counsel for the Government stipulate that the record in this 419 case may be considered on that issue, may be considered in Civil 474. We didn't want to actually consolidate the cases, your Honor, because of difficulties, if any appeal might be taken.

Mr. Atherton: The Government so stipulates, your Honor, with the understanding that it would be limited to the supplementary testimony taken here, that is, supplementary to the stipulated facts.

Mr. Pratt: Yes.

Mr. Wild: Your Honor, I rise now to ask that the Court, counsel approve that stipulation and add to the stipulation that the evidence taken in the

Alexander and Baldwin case—I haven't the number—concerning the Henry Waterhouse Trust Company issue other than the stipulation which may be filed there will be considered as a part of the record for all purposes in Civil No. 419.

The Court: Well, you say the evidence taken in the Alexander and Baldwin case relative to the Waterhouse Trust transaction. Well, now, the A. and B. is going to put in evidence?

Mr. Wild: Yes, your Honor.

The Court: In that?

Mr. Pratt: Our understanding in that, your Honor, was that following the hearing in this matter we would have a brief hearing in connection with 474, Alexander and Baldwin case, in which we would put in some evidence.

The Court: That is satisfactory.

Mr. Atherton: No objection, your Honor.

The Court: All right.

Mr. Wild: At this time, may it please the Court, as there is no jury and the issues of fact and law are to be heard by your Honor, I would ask that we follow this procedure: that we introduce in evidence the various instruments, [5] including the stipulations, decisions of the Court; then, with that background, we make an opening statement to the Court in which we outline our positions of law on the facts and the facts; then that we proceed with the facts involved in the stipulations; and then that we adduce such oral testimony as is proper after that. Counsel for the De-



fendant reserves his right, of course, to object on the admission of any of the items in evidence. I might say in that regard, your Honor, that counsel for the Defendant has been very generous with his time, and we have gone over all of the issues. He has seen, I believe, all of our exhibits, so that he is thoroughly familiar with what we would put in. Isn't that a fair statement?

Mr. Atherton: That is a fair statement, your Honor.

The Court: Well, I understand, then, that what you would propose to offer in evidence at this time are documents that you and opposing counsel have agreed were proper evidence.

Mr. Wild: Well, your Honor, no. Both sides reserve the right to object to paragraphs in the stipulations on any grounds that they deem advisable. I had understood before that counsel for the Government, that his objections were written in two paragraphs of the stipulation, and I just understood this morning that he intends to make other objections. But we would ask the Court to receive those in evidence and then rule on the objections later in the case. As I [6] understood from counsel, what he wants to do is to save any right to complain of error.

Mr. Atherton: May I interpose right here? I think, your Honor, that if we are going to deal with stipulation No. 2 first,—I assume you are going to discuss——

The Court: Let's see your stipulations.

Mr. Wild: Well, I was going to offer in evidence, I thought that I would offer in evidence the stipulations as they are numbered. They are stipulations No. 1 and No. 2. We needn't take them up in that order in the discussion. Perhaps it would be best if I would just go ahead. I think it would save time, and counsel could make his objections.

Mr. Atherton: Well, let me speak to the Court a moment. Your Honor, what I have in mind is, I think that the stipulation should be read. It is not very long. And as each paragraph is read, in order that you may be fully informed of what the facts stated are—all we are stipulating in the written stipulation is that the statements of fact made therein are true, reserving to each of us the right to object to the admissibility in evidence of the facts, all those stated to be true. Now, in the preparation of these stipulations it occurred to me that I should write into them certain objections. But since then it occurred to me that I should make objection to other paragraphs to which I failed to note in the written stipulations a specific objection. [7] Therefore, I want an opportunity when this stipulation is offered to object seriatim to each paragraph or accept each paragraph, raise no objection thereto, so the record may be perfectly clear.

The Court: Well, as long as the Court can keep track of the situation as it develops and not to become confused by a great mass of documentary

evidence put into the lap of the Court to digest, it seems to me all right to proceed with the two stipulations. They cover all this documentary evidence, do they? They mention it? .

Mr. Wild: They don't to the exclusion of all else, your Honor, because in the Hackfeld litigation I have and will offer in evidence the record in that case made up of complaint and answer, decision, findings of fact, and so forth, you see, your Honor. And we have referred to portions of those in the stipulation.

The Court: Well, wouldn't it be better first to read your stipulations to the Court before we take up the matter of offering the documents in evidence?

Mr. Wild: Very well, your Honor. I have no objection to that.

The Court: Have you got an extra copy for the Court?

Mr. Wild: Yes, your Honor. I have the original for the Court. This is the original.

The Court: The stipulation has been filed with the clerk? [8]

Mr. Wild: No, your Honor. It has just been signed.

The Court: This is stipulation No. 2?

Mr. Wild: That is right, your Honor.

The Court: Would that come first, or is there a number one?

Mr. Wild: I have a stipulation No. 1 which deals with the Henry Waterhouse Trust and note issue.

I would prefer to wait the reading of that stipulation until that stage of the case was reached. Now, your Honor, the reason this stipulation was not filed with the clerk of the Court was because both counsel reserved the right to object to anything that was in the stipulation. But we had gone over them and counsel informed me that there were two objections he wanted to make, one in stipulation No. 2 and one in stipulation No. 1. So it is a total surprise to me this morning when he says he has other paragraphs he now wants to object to.

Shall we proceed with the reading of stipulation 2?

The Court: Yes.

Mr. Wild: Then, your Honor, might I say this: I want to make my opening statement after the stipulation is read, and after these other things are adduced in evidence.

Mr. Atherton: Excuse me now before you start. Shall the Government interpose its objections as each paragraph is read?

The Court: I think that would be the proper thing to do. [9]

Mr. Atherton: And note its consent?

Mr. Wild: Stipulation No. 2: "It is hereby stipulated by and between the parties hereto through their respective attorneys that the following statements of fact shall be considered as true, and that either party may offer in evidence, oral testimony or any additional evidence, documentary or other-

wise not inconsistent with the facts herein stipulated.

“When the United States entered the First World War, H. Hackfeld & Company, Limited, (hereinafter referred to as ‘Hackfeld Co.’) was an Hawaiian corporation, which was then conducting and had conducted for many years prior thereto a sugar plantation agency, general merchandise store and other businesses and was a large factor in the Hawaiian sugar industry and in other businesses in the Territory of Hawaii; that Hackfeld Co., had been and was at that time controlled by German interests; that on or about January 28, 1918 and during March, 1918, the Alien Property Custodian of the United States seized the stock of Hackfeld Co., owned by German Nationals and gained control either directly or indirectly of approximately sixty-eight and one-half ( $68\frac{1}{2}$ ) percent of its capital stock.”

Mr. Atherton: The Government has no objection to that paragraph, your Honor.

Mr. Wild: Paragraph 2: “Prior to January 28, 1918—” [10] we would ask your Honor—well, maybe perhaps at the end I am going to ask that the whole stipulation be received in evidence, subject to objections to be ruled on afterwards. You are not waiving anything there.

Mr. Atherton: Well, I just want it understood that now to state my objection—do I have to repeat it again or shall I wait until the end?



The Court: Well, perhaps it would be more scientific to wait until it is offered in evidence.

Mr. Atherton: Very well.

Mr. Wild: Two: "Prior to January 28, 1918, the business of Hackfeld Co., had been seriously disrupted as a consequence of restrictions placed upon it by the Allied Governments as the result of its German affiliations and those of its stockholders. A plan for the reorganization of said company was formulated in the office of the Alien Property Custodian of the United States of America, (hereinafter referred to as 'Alien Property Custodian'), which plan as thereafter perfected is fully set forth in a resolution adopted by the stockholders of that company on July 19, 1918, a copy of which is attached to the Answer of the defendants, Respondents (exclusive of the Alien Property Custodian) filed in Isenberg et al., Plaintiffs, Complainants v. George Sherman, et al., Defendants, Respondents, being No. 149913 Dept. No. 2 in the Superior Court of the State of California, in and for the [11] City and County of San Francisco, (hereinafter referred to as the 'California Case') as Exhibit A thereof."

The Court: No objection to that?

Mr. Atherton: No objection to that, your Honor.

Mr. Wild: Three: "In the decision filed on March 16, 1926 in the California Case referred to in Paragraph II supra, the Court in its Findings of Fact found in part as follows:

## ‘VIII.

‘The organization of American Factors, Limited, as a new corporation to take over the business and assets of H. Hackfeld & Co., Ltd., as a going concern and whose stock, or trust certificates therefor, was to be sold to American citizens, was an integral part of said plan.

## ‘X.

‘It was the opinion of the Alien Property Custodian at all times after the seizure of said stock that the sale of the business and assets of H. Hackfeld & Co., Ltd., as a going concern and the preservation and continuance of its business rather than its disintegration were for the best interests of the stockholders of said corporation. He was also of the opinion and so determined that the best interests of the public and the proper administration of the Trading with the Enemy Act required such preservation [12] and continuance of said business.

## ‘XI.

‘It was the opinion and judgment of the Alien Property Custodian that it was necessary for the continued welfare and prosperity of said business and to public confidence in said business and to the successful consummation of his plan for its reorganization, that persons in Honolulu who were conversant with business of a similar nature should assume its direction. Such opinion and judgment were reasonable and proper. The defendants named in paragraph XX of the complaint, other than the

defendants H. L. Scott, Richard H. Trent and Trent Trust Company, Ltd., organized a joint subscription, substantially all the joint subscribers to which were known to and reported to the Alien Property Custodian, for the purchase of at least one-half of the stock of American Factors, Ltd., to the end that they might control and direct said American Factors, Ltd., in continuing the business of H. Hackfeld & Co., Ltd., and retain the agencies theretofore held by it, and so that the public invited to subscribe to the stock of American Factors, Ltd., might do so in reliance upon the management of said business by representatives of corporations conversant with and theretofore highly successful [13] in similar business, and to the end that said public having so subscribed, should be protected in its investment.

‘About 637 persons subscribed to and became stockholders of American Factors, Ltd.

#### ‘XXXIV

‘Long prior to the meeting of July 19th, 1918, the Alien Property Custodian was advised that the defendants, Castle & Cooke, Limited, Alexander & Baldwin, Limited, Matson Navigation Company, C. Brewer & Company, Limited, Welch & Company, J. B. Atherton Estate, Limited, Henry P. Baldwin, Limited, Charles M. Cooke, Limited, G. N. Wilcox, S. W. Wilcox, A. S. Wilcox, Wallace M. Alexander, George Sherman, J. F. Lowrey, F. C. Atherton, R. A. Cooke, and others, proposed to purchase more than one-half of the stock proposed to be issued by

the new corporation which was to succeed to the business of H. Hackfeld & Co., Ltd. The Alien Property Custodian was well acquainted with the identity and business connections of said defendants whose names were furnished to him.

‘It was the aim and purpose of the Alien Property Custodian, stated and believed by him to be for the best interests of said corporation and its stockholders, and it was in fact to the best interests of said corporation [14] and its stockholders, that a large portion of the trust certificates mentioned in said stockholders’ resolution of July 19, 1918, should be purchased by persons familiar with the sugar agency business in the Hawaiian Islands, and by persons who could properly and efficiently manage said business, and in whom the subscribing public would have confidence. To that end it was the desire of the Alien Property Custodian and his plan, that a large portion of said trust certificates should be purchased by those persons and corporations who were then engaged in the plantation agency business in Hawaii.

‘It was the purpose of the Alien Property Custodian to induce the defendant firms who were then engaged in the sugar agency business, to subscribe to said trust certificates in order to insure the success and continuance of the business of H. Hackfeld & Co., Ltd., or the successor corporation to be formed. It was believed by the Alien Property Custodian that in that manner he could best secure the prosperity of the corporation which was to take

over the business and assets of H. Hackfeld & Co., Ltd., under said plan adopted by the stockholders of H. Hackfeld & Co., Ltd., on July 19th, 1918. It was the opinion of the Alien Property Custodian that the public of Hawaii would more readily [15] subscribe to the trust certificates to be issued under said plan if the control and management of said successor corporation were in the hands of the defendant firms then engaged in the sugar agency business in the Territory of Hawaii. The opinion and belief of the Alien Property Custodian in these respects were reasonable.

‘The Alien Property Custodian therefore desired the purchase by said defendants and their associates in this finding first above named and referred to, of a large part of the trust certificates representing the stock of American Factors, Ltd., and acquiesced in the allotment to said defendant firms and their associates upon their subscriptions of one half of said trust certificates.’ ”

Mr. Atherton: Now, your Honor, the Government objects to the admissibility in evidence of all the paragraphs recited in paragraph three of the stipulation for the reason that the defendant, the United States, was not a party to the proceedings before the state court in the Hackfeld litigation, and therefore the recital of the findings of fact by that court, California court in that case, is not only hearsay but it is incompetent, irrelevant and immaterial to any issue involved in this suit. And if it is



admitted over the Government's objection in evidence, we wish the record to show that the evidence shall be limited strictly to this particular [16] action.

Mr. Wild: May it please the Court,—

Mr. Atherton: Now, in support of the Government's position as to the objection, I have had occasion to examine Jones' Commentary on Evidence, Second Edition, Volume 4 at page 3368, Section 1816, and footnote 16, reciting a number of cases which support the Government's position with respect to this objection. Also I assume that later counsel for the Plaintiff may offer in evidence a certificated copy of the court's findings of fact, and in anticipation of that the same objection obtains with respect to that document as to these recitals of the particular paragraphs taken therefrom.

Mr. Wild: May it please the Court, the objection is wholly erroneous. The thing that the United States Government has done is to deny a deduction for the defense of this very suit. They are bound by what happened in that suit just as much as we are. The United States Government doesn't have to be a party to every transaction that involves Federal taxes. If it did, the taxpayer would have no defense at all. The taxpayer would have to retry every issue with the Government. I have never found any authority, I have never heard one cited before in a Federal tax case to the effect that when the Government denies the deduction of an expense

of defending certain litigation that the litigation itself is [17] hearsay to the Government.

Mr. Atherton: Your Honor, the pleadings in that case are properly admissible from the Government's viewpoint. They show the gist of the action and what the parties were suing for. It is of no importance to this Court, we believe, as to what the findings of fact were in that case. All that this Court may be possibly concerned with from the Government's viewpoint is that any evidence with respect to the Hackfeld litigation may be received only for the purpose of showing that what the issue was determined in that case, not otherwise.

Mr. Wild: Well, counsel's statement, then, is an admission that this all goes in because the Court's decision——

Mr. Atherton: No.

Mr. Wild: ——findings of fact and law that were based on that, that the decision was based on, are the ultimate determination when affirmed on appeal as to the nature of the case, your Honor. In this particular case the record will show that there were 32 volumes of transcript of testimony; that the trial lasted nine months, the most titanic legal struggle, I think, on the west coast in at least my time. During the trial of such length it is obvious that the various positions taken in the complaint and answer may have been modified many times in the trial. The Government bound itself by whatever the Court decided in that case as [18] to the nature of the complaint, as to the nature of the defense,

and as to the finding of evidence on the trial. The Government denies a deduction, and the facts as shown and decided by the Court are material in enabling this Court to determine whether or not the Government's denial was proper. I submit, your Honor, that counsel's own statement shows very clearly that the Government's position is unfounded.

Mr. Atherton: Your Honor, I'd like to respectfully call your attention to paragraph 14 of the stipulation which you have before you. You will find it on page 11.

Mr. Wild: Wait a minute. We are not there yet.

Mr. Atherton: But this supports my objection. There you will find a statement of the memorandum filed by the trial judge in that case, which in the opinion of Government counsel, taken together with the pleadings in that case, should suffice to show the issue determined in that case without regard to a detailed recital of the findings of fact found by the court.

Mr. Wild: May it please the Court, it is obvious that counsel is much concerned by the effect of the detailed findings of the court upon the Government's case. He finds that it is consummate to victory to have those in. Otherwise he wouldn't object. Now, may it please the Court, under California practice, as your Honor well knows, it is required that after a short summary decision findings of fact and [19] conclusions of law be found by the Government. There is no judgment entered in the case until after that step is taken. Prior to that time

that step is taken the court may change its opinion. And it is submitted that any part of the proceedings in this cause is at issue here because the Government has made it so. Counsel will await the ruling of the Court, your Honor.

The Court: Well, it is understood that the Court rules on these objections as they are made now, after the reading of the stipulation or at the time when the stipulation is offered in evidence. I assume that the stipulation will be offered in evidence.

Mr. Wild: Yes, your Honor.

The Court: So we might just as well assume that the stipulation is now offered in evidence.

Mr. Wild: Yes, your Honor.

The Court: My view is that with the material set out in paragraph 14, that is, the opinion which was the final decision of the court in the case, that all that is necessary for any purpose here, that that is all that is necessary for any purpose here that I can see.

Mr. Wild: Your Honor, may I call your Honor's attention to one error in that ruling? This decision by the court set out in paragraph 14 is not the final decision at all. The final decision is exactly what we have been quoting from; [20] the final decision and findings of fact of the court, which instead of being filed on January 6, 1926, was filed on March 16, 1926. Your Honor is right in the conclusion that the final finding of the trial court is the issue that is before the Court. And the final finding of the trial court is the decision and judgment that was

issued in this Court on March 16, 1926. I have a certified copy of that, your Honor, and if your Honor lets in the preliminary finding referred to in paragraph 14, your Honor would have excluded from this case the final decision of the lower court. And it is submitted that on your Honor's own statement that it is the final decision of the Circuit Court that it is inadmissible with the findings of fact on that statement. It seems to me that the paragraph should be received. We would feel loath, your Honor, to introduce in evidence in this cause the 32 volumes of transcript of testimony. Unless and until we get in the record not the pleadings of the parties but what the findings were, and what the facts were as determined, how can this Court pass upon the meat of this litigation? And that is the precise thing that counsel for the Government fear. They know that if your Honor passes on the meat of this litigation that their contentions are groundless.

The Court: Now, you have there the final decision in the California court? [21]

Mr. Wild: Yes, your Honor, and I am going to offer it in evidence.

The Court: Suppose you offer it now—the foundation is laid—and let the objection then be to the offer of that as evidence.

Mr. Wild: I would now offer in evidence, may it please the Court, the decision, findings of fact and conclusions of law of the judge, the trial judge, in that certain cause in the Superior Court of the



State of California in and for the City and County of San Francisco, in the case of J. C. Isenberg, et al., versus George Sherman, et al., No. 149,913 in that cause. I have a certified copy of it here, your Honor, which shows on the face that it was filed on March 16, 1926, and it shows that that is the final decision of the court.

The Court: You are acquainted with this?

Mr. Atherton: Yes, I have read that. And as far as I have been able to ascertain from reading it, your Honor, it doesn't modify in any respect the memorandum opinion of the trial judge which was filed on January 6, 1926. It merely amplifies it. And I still repeat the Government's objection to the admission in evidence of this certified copy of the court's so-called final decision, findings of fact and conclusions of law. We are not trying in this case, your Honor, the Hackfeld suit. At the time the parties co-defendant in [22] that suit incurred liabilities for these expenses, litigation expenses that they are seeking as a deduction in the present tax suit, they were not aware of the outcome of that litigation. The Government's defense is predicated on the ground that as the litigation progressed the liability for the expenses was incurred and paid by all parties litigant, and that they were incurred and paid then without respect to the ultimate outcome of the litigation; and their deductibility for Federal income tax purposes was determined at the time that the liability therefor was incurred and paid, and not until the litigation

was concluded. Where you have paid a liability, there can be no question as to its subsequent accrual; the payment discharges the liability forthwith.

The Court: May I ask now, just what is the materiality of this decision which was rendered here some four years after the tax deduction was claimed as a basis for this suit?

Mr. Wild: Well, your Honor, I hadn't intended at this time to open this statement—perhaps it would be as well for me now to make a statement of our position. Counsel's statement this morning comes as a complete surprise to me. I was led to believe up to no later than yesterday that he had no-objection to this whole record going in. If so, I would have had authorities to prepare. I told him I was going to put them in. He stated frankly to me that neither he nor the Department had ever seen this decision, that it was wholly [23] new to him. I loaned it to him over a week-end so that he might read it. But may I digress a moment in my theory of the cause? Your Honor, the findings in this decision became final in 1932 when the Supreme Court of the State of California refused to recall the remittor in the opinion of the court, which I will come to subsequently. At the outset and before the litigation was filed, your Honor, it was rumored that the persons referred to in this paragraph who under the guidance of the Alien Property Custodian had brought American Factors into being were to be sued for fraud and damages

claimed against them. As we would see further in other paragraphs of the stipulation, knowing that they were going to be sued for fraud and as the only actors that could make American Factors liable, they would be the ones, individuals and corporations. American Factors, if it were liable under that litigation, would only be liable because of their acts. They very properly entered into an agreement among themselves to bear the cost of the Hackfeld litigation until there was a final determination of the cause. They bore, paid up a certain amount of the cost of the litigation.

When there was a decision finally determined by the court that everything they had done had been for the benefit of American Factors and that there was no fraud, at that moment, your Honor, there arose in the law a complete obligation upon the part of American Factors to reimburse all the litigation expenses. Every act that had been done was for the benefit of American Factors.

Under the law of restitution, and under the opinions as cited by the courts—to which I will hereafter in my opening statement refer, your Honor—there is no question that under these facts that the Government now finds they can't stipulate to without losing their case. There is no question that under that law there arose the obligation to reimburse these people for their expense. And I have the decisions of eminent courts on that, and I also have the restatement of the law concerning restitution.

Now, may it please the Court, the Government knows in this cause that it is material to the issue to decide the deductibility, that the exact nature of the holding and the finding be before this Court. They don't think this is mere surplusage. They know from the very averment of the objection to this evidence going in—and it is the final decision of the lower court which only becomes final and became final in 1932. And it was entered three months after this memorandum. The Government knows that with that in the record there is a complete showing that in the year 1932 when that case became final there was an obligation on American Factors to reimburse all the litigants.

So that if I might say so—just adverting to a part of my opening statement and the law upon which it is founded— [25] that this decision being the very decision and the point at issue, is not only material to the issue but when it becomes final in 1932 it lays the foundation for the Plaintiff's case, and lays the destruction, I might say, of the Government's position. And the Government is just realizing it.

Now, may it please the Court, I don't want to go into my opening statement at this time. I don't want to state the law on some of the issues here as yet. But I do want to call your Honor's attention to some of the authorities. And it seems to me, your Honor, it is obvious that on any authority these findings could be material, and they must be re-

ceived as laying a foundation for the determination one way or another.

For instance, it is a well-established rule that one person, or persons who have an interest in a trust fund, or having an interest in a corporate history, or at their own expense take proper proceedings to save the funds from destruction, or to restore the funds, are entitled to reimbursement either out of the funds or by proportional contribution from those who accept the benefits of their efforts.

Under those paragraphs of the findings, your Honor, the Court would have to hold that it was found by the trial court and became final in '32 that these people have defended American Factors. They are found to be without fraud. They protected American Factors from a judgment claim of ten million dollars. And it shows their part in it, and that their part came under the direction of the Alien Property Custodian; and at that time—which theory is affirmed in *Trustees of International Improvement Fund versus Reno*, 26 Law Edition 1157 by the Supreme Court of the United States—at that time there was an obligation to reimburse the other defendants in the case that arose for American Factors.

Now, may it please the Court, counsel is attempting to bring out *Ab initio* a lot of positions which probably we should have stated to start with. He talks about the accrual basis, American Factors is on the accrual basis. The uniform rule of law is



that when a corporation is on the accrual basis for income tax purposes that it cannot accrue items which are on litigation until the final act is taken concluding the litigation.

The latest decisions in the Supreme Court of the United States, the latest decision, Dixie Pine Products Company against Commissioner of Internal Revenue, 1944, the headnote states,

“A taxpayer who acts on the accrual basis may and should deduct from gross income a liability which really accrues in the taxable year. And in order truly to reflect the income of a given year, all the events must occur in that year which fixed the amount and the facts of the taxpayer’s liability for items of indebtedness deducted, [27] though not paid. A taxpayer acting on an accrual basis cannot deduct a liability which is still contingent and is being contested by him.”

Then a note as to this case:

“The rule prohibiting the deduction for Federal income tax purposes of contingent liabilities is frequently applied where the liability in question depends upon the outcome of litigation.”

That is exactly what this liability depended upon. It depended upon the outcome of the litigation, and the nature of that outcome.

I have no hesitency in telling your Honor that had the decision of this trial court been that respondent other than Factors had been fraudulent, as was the Plaintiff’s claim, and had these other findings been reversed, that American Factors then

would not have been authorized to accrue any part of the legal expense of H. Hackfeld and Company. You see, it is our contention that under the accrual law and under these very recent cases sustaining it, that once the very nature, the essence of the claim is shown—and that essence is shown in the findings of the trial court but not binding until they become final—under that very essence are we entitled to the deduction. And the Government fears it because otherwise they wouldn't make any objection to it.

The Court: Well, wouldn't the costs and fees have been [28] the same, no matter which way the case had gone?

Mr. Wild: Oh, no, your Honor. The amount would have been the same, your Honor, but let me just picture it this way: the amount would have been identical but the question as to who was to bear it was different. If your Honor please, all these people actually carried out a plan under the guidance of the Alien Property Custodian, and if there had been any fraud found in that plan, American Factors wouldn't have paid a cent of the litigation expenses. It was a corporation. The whole of that litigation expense would have been paid by the other defendants because American Factors could not be liable as between itself and those who were fraudulent to pay any part of the expense of those who were fraudulent. Let me put it this way, your Honor: I hire an agent; the agent does a fraudulent act, or another does a fraudulent act for me; I am not liable to that agent to pay the cost of ex-

pense and litigation expense that his fraud causes me. As between myself and that agent, I make him pay the whole bill.

Well, frankly, here the agreement that was entered into at the outset was that American Factors acted as this banker, put up the money for litigation expenses that were approved by a group that I will come to later; billed these people, billed these people for the whole cost of the litigation until three hundred ninety-six thousand had been paid up; [29] and then after the decision in the lower court—and that became final in the upper court—the balance of litigation expenses was paid, which was some eighty-three thousand in that year, and a small amount had been paid in addition over the year. Now, right at that time, your Honor, when these people were held to have been, finally held to have been free from blame, and as every act done was an act for the benefit of Factors under the law of restitution, American Factors was obligated to reimburse them. And not only that—there is a legal opinion that was given on it. The stockholders voted the approval of it. All this I will show later.

So that, your Honor, it is submitted that it is the gist of this cause, as set forth in the findings and the decision of the trial court, which is the final decision of the trial court, but it didn't become final until in 1932. It is the gist of that that is necessary so that this Court can pass upon the issues of law that are involved in it.

The Court: Well, wasn't that an afterthought, though, coming to the Factors and its managing officers?

Mr. Wild: 'No, your Honor.

The Court: To pay this cost of litigation in full?

Mr. Wild: No, your Honor, no.

The Court: To reimburse those who had agreed to and had carried the burden of it because they had much to lose when charged with fraud? When it turned out the other way, I am [30] asking, wasn't it something of a motion of gratitude, benevolence, to reimburse them what they had been out?

Mr. Wild: No, your Honor, not at all. It is clearly legal liability on the Factors' part. The point I am making there is this, your Honor: under the law of restitution, as it is understood, there was a legal or equitable obligation; and in the restatement of the law of restitution, it doesn't make any difference whether it is legal or equitable; obligations that arise when out of justice of the situation, when those who have borne the brunt of conferring a benefit—and the defense of a suit is a benefit—have been shown to have gained something for the other person that was involved. Now, Factors was involved in a secondary way. While it is true there was an allegation that Factors was a party to the conspiracy, it, as a corporation, apart from its officers, as between themselves, couldn't be a part of any conspiracy at all. It could have the obligation of a conspirator to the outside public, your Honor, but as between itself and the fraudulent

actors it would have a right against them for whatever damage the fraudulent acts had caused them. Now, that is very clear-cut. And it is submitted, your Honor, that right here in 1932 when the decision became final American Factors became legally or equitably liable to reimburse.

Now let me read to your Honor from authority, the restatement of the law on restitution: [31]

“Section 1. Unjust enrichment. A person who has been unjustly enriched at the expense of another is required to make restitution to the other.

“Comment: A person is enriched if he has received a benefit (see Comment b). A person is unjustly enriched if the retention of the benefit would be unjust (see Comment c). A person obtains restitution when he is restored to the position he formerly occupied either by the return of something which he formerly had or by the receipt of its equivalent in money.

“b. What constitutes a benefit. He confers a benefit not only where he adds to the property of another, but also where he saves the other from expense or loss.”

Just as here, by coming in, putting up their money in the defense of the suit, they have saved American Factors from that expense, and they conferred a benefit when they got the assets of H. Hackfeld and Company, under the circumstances as are shown in this decision of the trial court, for the benefit of American Factors.

“c. Unjust retention of benefit. The mere fact



that a person benefits another is not of itself sufficient to require the other to make restitution therefor. Thus, one who improves his own land ordinarily benefits his neighbors . . .”

He is entitled, however, to the restitution where it is unjust [32] for the other to retain the benefit.

Now, officious conferring of a benefit: “A person who officiously confers a benefit upon another is not entitled to restitution therefor.”

Now, did these people officiously confer the benefits? Why, your Honor, the benefit here is getting the business and assets of American Factors, Limited, away from H. Hackfeld and Company.

The plaintiffs in the suit claim there was a ten million dollar damage. The method of conferring that benefit, who conferred it, how it was conferred, the fact that they were not officious in conferring the benefit—all those things are shown in this finding of fact by the trial court which became final, however, in 1932 when all the appeals had been terminated.

How could your Honor, for instance, determine whether these people when they took part in the formation of American Factors were officious, whether what they did came under this rule of law, or whether they didn't, unless we have the holding of the court on it? And we are bound by that holding of the court. If that holding of the court had said that these people were officious, we'd be bound by that holding as against the United States Government, or they are bound by it as against us.

Now, going on with this: "Policy ordinarily requires [33] that a person who has conferred a benefit either by way of giving another services or by adding to the value of his land or by paying his debt or even by transferring property to him should not be permitted to require the other to pay therefor, unless the one conferring the benefit had a valid reason for so doing."

Now, the discharge of a duty I owed to another, in topic 3 of the restatement, is another basis for the receipt of the evidence. Suffice it to say, your Honor, in summary, the Federal Government is wholly bound in its tax contentions by whatever the determinations were in that case. This Court is entitled to have before it the determining issues of law raised in good faith by the plaintiff, those findings of fact, and it is a necessary part of the record of this cause and there couldn't be a trial of this case, your Honor, without that in it. I don't see how there could be.

Mr. Atherton: Your Honor, without waiving in any respect the Government's objection to the admissibility in evidence of these findings, and so forth, I want to call the Court's attention to the fact that if you should happen to examine those findings you will find that the court did not include as a matter of law—you will find that there was no trustee relationship existing between the incorporators and those who became the stockholders of American Factors and American Factors; that there was no agency relationship [34] established between

those parties; and that, as a matter of fact, the Hackfeld litigation grew out of acts of the alleged conspirators before the American Factors even was organized as a corporation. It was an alleged conspiracy to incorporate and organize the American Factors to take over and acquire the assets of the Hackfeld Company. So I think that that suffices on that aspect of it.

Now, with respect to the accrual of the liabilities, counsel for the Plaintiff cited the case of Security Flour Mills Company versus Commissioner of Internal Revenue, 321 U. S. 281, in support of his position that despite the fact that the legal expenses and litigation expenses were paid currently as they were incurred by the parties litigant, the co-defendants, according to a pre-trial agreement between themselves, he takes the position that under the rationale of that case nevertheless at the conclusion of the litigation, to wit, 1932, all of those expenses became a proper accrual to American Factors. I wish to call the Court's attention to the decision of the U. S. Court of Claims in the case of Chestnut Securities Company versus United States, 62 Federal Supplement, page 574 at page 576, a decision which was handed down on October 1, 1945, after the decision in the Security Flour Mills Company case, and there the U. S. Court of Claims undertakes to discuss and to analyze the opinion in the Security Flour Mills Company case and points out aptly there, [35] as I pointed out here, that in that case the taxpayer had denied liability but paid it, and

the court said, "We think it thereby 'accrued' the taxes and interest, if accrual is requisite at all, in the case of the debtor, when actual payment has occurred."

Elsewhere in that opinion you will find where the court says that there can be no accrual when there is a discharge of liability by payment.

Now, I take it that the evidence in this case will show that these expenses, as they were incurred by these co-defendants, were actually paid; that American Factors billed them for their pro rata share and actually discharged the indebtedness as it went along. And then, while it is true undoubtedly, as the evidence will show, that American Factors carried the entire amount as a deferred item on its books. There is nothing that will be shown in the record, so far as I understand—and I don't expect that the oral testimony will prove otherwise—that there was any dispute as to liability or that there was any belief or belief conveyed to the stockholders, the co-defendants, by the American Factors that American Factors felt that at any time it might be under obligation to refund this \$396,000 which it had collected from its co-defendants to them at the conclusion of the litigation. So that there was no dispute as to liability there. And the mere fact that American Factors carried the entire amount as a deferred item on its books doesn't in itself establish that there was any issue between the co-defendants and American Factors as to the ultimate liability for those litigation expenses.

And as far as this so-called unjust enrichment benefit, the parties who benefitted here were the individuals and person who were named as the alleged conspirators rather than American Factors, because American Factors obviously couldn't be a party to a conspiracy when it was non-existent.

Mr. Wild: Your Honor, counsel has stated there one reason why that very material——

The Court: I think I will allow this decision to be put in as an exhibit.

Mr. Wild: Your Honor, might I state this, in our stipulations we have annexed exhibits to them, and we have called them in one "A," starting with "A," "C," "B," "C" and "D." And in the other stipulation we started numbering them 1 and 2. Might this exhibit be numbered Plaintiff's 1 so that there wouldn't be any confusion when we talk about exhibit 1?

The Court: All right, I see the point.

Mr. Atherton: I want the record to show that the Government takes an exception, your Honor.

The Court: All right. "P-1."

(The document referred to was received in evidence as Plaintiff's Exhibit P-1.) [37]

The Court: I think the reporter has been working at rather high speed, and I think we will take a brief recess now.

Mr. Wild: Very well.

(A short recess was taken at 11:15 a.m.)



## After Recess

Mr. Wild: May it please the Court, if we may proceed, I thought at this time, in view of the fact that your Honor has admitted this stipulation, P-1, the decision and findings of fact of the trial court, that I would like to offer in evidence a photostatic copy of the complaint in that cause, certified by the Clerk of the Federal Court, and ask that it be received as Exhibit P-2.

The Court: This is what, it is a photostat of what?

Mr. Wild: A photostatic copy of the complaint in the Hackfeld suit filed in California.

The Court: Any objection?

Mr. Atherton: No objection, your Honor.

The Court: That is Exhibit P-2.

(The document referred to was received in evidence as Plaintiff's Exhibit P-2.)

Mr. Wild: And at this time, your Honor, I would like to offer in evidence a photostatic copy, certified by the Clerk of the Federal Court, of the answer filed on behalf of the Defendant with exhibits annexed thereto. [38]

Mr. Atherton: No objection.

The Court: You said certified by the Clerk of the Federal Court?

Mr. Wild: No, California court, your Honor, not the Federal Court.

The Court: This is an answer to this?

Mr. Wild: That is the answer to the Hackfeld complaint with the exhibits annexed.

The Court: Received as Exhibit P-3.

(The document referred to was received in evidence as Plaintiff's Exhibit P-3.)

Mr. Wild: And then I have here an answer of the Alien Property Custodian of the United States, certified copy thereof, certified by the Clerk of the Superior Court of the State of California, in the Hackfeld litigation, and ask that that be received as P-4.

Mr. Atherton: No objection to that.

The Court: All right.

Mr. Wild: It just makes a picture, your Honor.

The Court: That is the Custodian?

The Clerk: Alien Property Custodian.

(The document referred to was received in evidence as Plaintiff's Exhibit P-4.)

Mr. Wild: Now shall we proceed with the stipulation?

The Court: Yes. [39]

Mr. Wild: We had completed the first three paragraphs.

The Court: Right.

Mr. Wild: There was an objection made on three, and your Honor suggested that we offer the decision, which we have done. I assume that your Honor makes the same ruling about that paragraph in the stipulation and as to the objection.

The Court: About the paragraph?

Mr. Wild: Yes.

The Court: Yes, if that same material is in the decision, I don't know any reason why this should be ruled out in the stipulation.

Mr. Atherton: I just thought it was redundant, your Honor.

Mr. Wild: It presents a short study of the case.

The Court: Yes. All right.

Mr. Wild: Shall we proceed with paragraph four, your Honor?

The Court: Yes.

Mr. Wild: "The subscription for trust certificates for shares of American Factors, Ltd., is attached to the Answer filed in the California case as Exhibits B and C thereof and shows that the participants subscribed to a total of twenty-seven thousand (27,000) shares of stock in blocks of stock, ranging from one hundred (100) to two [40] thousand five hundred (2,500) shares, conditioned upon the allotment of a minimum of twenty-five thousand (25,000) shares to the group; that the joint subscription agreement was accepted for a total of twenty-five thousand (25,000) shares and trust certificates were issued to and paid for by the said signers of the said joint subscription agreement for the total of said twenty-five thousand (25,000) shares; that trust certificates, representing the other twenty-five thousand (25,000) shares of the Plaintiff's capital stock were allotted to and paid for by approximately six hundred and fourteen (614) other persons and corporations."

Mr. Atherton: No objection.

Mr. Wild: "V. That trust certificates, representing fifty thousand (50,000) shares of the capital stock of Plaintiff, were issued and sold for the price of one hundred and fifty dollars (\$150.00) per share and the total stated consideration of seven million, five hundred thousand dollars (\$7,500,000.00) was duly paid in cash or United States Liberty Bonds at par to Hackfeld Co., and in exchange therefor Hackfeld Co., conveyed all of its assets and businesses as a going concern on August 20, 1918 to the Plaintiff and Plaintiff assumed all liabilities of Hackfeld Co. and of the business, and Plaintiff thereafter continued the business as a going concern."

Mr. Atherton: No objection. [41]

Mr. Wild: "VI. That included among the subscribers participating in the joint subscription agreement were persons who were incorporators of American Factors, Limited, and persons who subsequently became officers and directors of that corporation or of Hackfeld Co., or who otherwise participated in the business and affairs of Plaintiff."

Mr. Atherton: No objection.

Mr. Wild: "VII. That about June 1924, the then directors of American Factors, Limited were informed that former stockholders of Hackfeld Co., then dissolved, threatened to initiate litigation; that at that time it was not known what form the litigation would take nor who would be the Defendants; that the Board of Directors of American Factors,

Limited, after consideration, authorized its president to secure counsel for American Factors, Limited, to prepare for and to conduct the defense in the threatened litigation; that American Factors, Limited procured the services of attorneys to represent it in the threatened litigation.”

Mr. Atherton: No objection.

Mr. Wild: “VIII. Prior to the filing of the suits in the threatened litigation above mentioned, twenty-one of the twenty-three persons and corporations who had joined in the joint subscription agreement for the shares of stock of American Factors, Limited, described in paragraph IV of this stipulation, entered into a written agreement under date of July 28, 1924, a true copy of which is annexed hereto as Exhibit 1 and made a part hereof, wherein they agreed to prorate on an original per share basis the expenses of the aforesaid threatened litigation if they were joined as defendants therein. Two of the individuals who had joined in the joint subscription agreement hereinbefore described did not participate in the agreement of July 28, 1924, to share the expenses of the threatened litigation because they had died. American Factors, Limited was not a party to the agreement of July 28, 1924.”

Mr. Atherton: No objection.

Mr. Wild: Now, the Exhibit 1 is as follows, your Honor:

“The undersigned persons and corporations hereby agree each for himself and itself and not for the others of them with Allen W. T. Bottomley,



C. R. Hemenway, F. C. Atherton and R. A. Cooke, provided only that he or it is made a party defendant or one of the parties defendant to the suit or suits hereinafter mentioned but not otherwise, to contribute and pay on demand such a proportion of all of the costs and expenses of every description hereinafter mentioned as the number of shares represented by the trust certificates hereinafter mentioned originally subscribed for and issued to them bears to all of the shares represented by all of the said trust certificates subscribed for and issued to all of the subscribers hereto who are made parties defendant to the suit [43] or suits hereinafter mentioned or any of them.

“The costs and expenses hereinbefore mentioned are such as the said Allen W. T. Bottomley, C. R. Hemenway, F. C. Atherton and R. A. Cooke or any three of them acting in the name or on behalf of all of them have already paid or incurred or shall or may hereafter pay or incur in or about or in connection with the defense of any suit or suits which may be instituted against the undersigned or any of them upon or pursuant to the notice and demand made by J. F. Neylan as attorney for Mrs. Paul Isenberg and others, dated June 24th, 1924, or by any of the stockholders of H. Hackfeld & Company, Limited, an Hawaiian corporation which has been dissolved or is in process of dissolution by reason of or arising out of either the organization of the American Factors, Limited, or the sale and transfer of the assets of H. Hackfeld & Company, Limited,

to the said American Factors, Limited, or the appointment of trustees by H. Hackfeld & Company, Limited, of the whole of the shares of the capital stock of American Factors, Limited; or the sale and issue by the said trustees of trust certificates of shares of the said American Factors, Limited, to sundry persons, firms and corporations or any of the acts and deeds of the said trustees.

Dated, July 28th, 1924."

Then are the signatures of Alexander and Baldwin, Limited, 2300 shares, by John Waterhouse, vice-president; Henry P. [44] Baldwin, Limited, and the other signatures which I do not need to read, your Honor. That, I take it, is received as part of the paragraph.

"IX. That the suit of J. C. Isenberg, et al., Plaintiffs, Complainants, hereinafter called 'Hackfeld Plaintiffs' v. George Sherman . . . American Factors, Limited, et al., Defendants, Respondents, hereinafter called 'Hackfeld Defendants,' and which litigation, hereinafter called the 'Hackfeld litigation,' was commenced in August and September 1924; that identical complaints in the Hackfeld litigation were filed in the Circuit Court of the First Judicial Circuit, Territory of Hawaii, and in the Superior Court of the State of California in and for the City and County of San Francisco; that by stipulation between the parties the case filed in the California court was tried; that American Factors, Limited was one of the defendants named in the

Hackfeld litigation and the twenty-three corporations and persons, including the representatives of the estates of the two deceased persons who had signed the joint subscription agreement, were joined as Hackfeld Defendants.”

Mr. Atherton: No objection.

Mr. Wild: “X. The Supreme Court of California, as reported in 212 Cal. 454, 461; 298 Pac. 1004 at page 1006, said of the aforesaid complaint:

‘. . . The purport of the complaint is to require the [45] individual and corporate respondents to account to complainants for all matters and things concerning the transfer and sale of the assets of H. Hackfeld & Company, Limited, to American Factors, Limited, an Hawaiian corporation, organized for the express purpose of taking over the business and assets of said H. Hackfeld & Company, Limited. The gist of the complaint affirms the sale and alleges that the sale and transfer were the result of conspiracy, collusion, and fraudulent connivance on the part of certain of the respondents, whereby they secured the assets and profitable business of H. Hackfeld & Company, Limited, at a price far below its alleged intrinsic value, in fraud of and to the financial injury of complainants. The object of the suit is to require respondents to account to complainants for the transfer and sale of the assets of H. Hackfeld & Company, Limited, to American Factors, Limited, and to account for the difference between \$7,500,000, the price at which the assets were sold, and the actual value of the

assets of the corporation at the date of transfer, which appellants claim to be \$17,500,000. The Alien Property Custodian of the United States was made a respondent, but no relief or judgment is sought against him, it being alleged that his interest as trustee for certain of the stockholders "is identical with the [46] interest of the complainants herein," but not having joined as a complainant, he is joined as a respondent, "so that, as such trustee, he may properly receive the benefits of any judgment which may be entered herein." Certain other persons are made formal respondents for the same reasons.' "

Mr. Atherton: The Government makes the same objection as to the admissibility of that paragraph as it did with respect to the other on the finding of facts and conclusions of law of the Circuit Court of California.

The Court: Well, I don't quite see the purpose of that.

Mr. Wild: Well, the purpose of it, your Honor, is simply that it shows the determination of the court as to its construction of the complaint, what was claimed. And it seems to me that it is a part of the litigation which the Court should have before it when it is passing on the other matter.

The Court: Well, I don't see what is particularly prejudicial to any interest here. The objection is overruled.

Mr. Wild: I might say, your Honor, that some of these paragraphs are the background so that you get a complete picture of a portion of the case. Paragraph XI—

Mr. Atherton: Your Honor, may I have the reporter read that? Did you overrule the Government's objection?

The Court: Yes. [47]

Mr. Atherton: I didn't quite hear.

The Court: You reserve an exception?

Mr. Atherton: I wish to note an exception.

Mr. Wild: "XI. That the complaint in the aforesaid action, in Paragraph XXXVI thereof, in substance, alleged that American Factors, Limited took and received all of the assets of Hackfeld Co., with full knowledge of all the facts and circumstances set forth in the complaint, and with full knowledge of and concerning the rights and equities of the stockholders of said Hackfeld Co., and did thereafter handle the said assets and conduct said business in trust for the protection by it of the rights and equities of said stockholders and the complainants, and said American Factors, Limited did so mismanage said business and did so improperly handle said assets as to cause great damage to said assets and business and great injury to the rights and equities of said stockholders and complainants, and that the American Factors, Limited was a party to the fraudulent scheme and the conspiracy therein alleged, and holds said business and said property in trust to protect the rights and equities of complainants, and that by its mismanagement of said business and said assets, it has caused further and additional loss to said business and to said stockholders of said Hackfeld Co., and to the complain-



ants in the sum of upwards of Two and One-Half Million Dollars in addition to all other damage and loss suffered by complainants."

Mr. Atherton: Your Honor, since the complaint is in, why, the Government feels that paragraph is redundant. It should be struck from the stipulation.

Mr. Wild: Well, it should be but it is a short way of expressing it.

The Court: I think that that is true. That occurred to me, that in the preceding paragraph perhaps is redundant. Well, it is before the Court. You object to it?

Mr. Atherton: Well, no, I won't object to it.

The Court: All right.

Mr. Wild: It is a shorthand picture for your Honor.

The Court: That was the purpose of having this stipulation?

Mr. Wild: Yes.

The Court: To read and consider it paragraph by paragraph.

Mr. Wild: Paragraph XII. "The prayers in the above referred to complaint, among others, included the following:"

Now, I don't want anything in here that is redundant, but both counsel asked to put in just for the picture for the Court the paragraphs that they thought were material, and I thought that by putting them in here we are saving some time for the Court.

The Court: Well, now, instead of reading those,

just [49] pass that and I can read those later and save some time.

Mr. Atherton: No objection.

Mr. Wild: None at all, your Honor? Paragraph XIII.

“That the attorneys employed by American Factors, Limited investigated the facts and matters pertaining to the Hackfeld litigation and prepared a joint answer on behalf of American Factors, Limited and the other Hackfeld Defendants, except the Alien Property Custodian and the nominal Defendants and signed and filed the answer on behalf of such Hackfeld Defendants. A separate answer was filed on behalf of the Alien Property Custodian.”

Mr. Atherton: No objection.

Mr. Wild: “XIV. The trial judge filed the following memorandum on January 6, 1926:

‘I am of the opinion that (1) no actual fraud on the part of respondents was shown; (2) no constructive fraud existed; (3) the price paid was adequate; (4) the suit is not barred by the Hawaiian statute of limitations; (5) plaintiffs were not guilty of laches. Frank J. Murasky, Judge.’

The trial judge’s memorandum quoted above is taken from the report of the Supreme Court of California in the case of *Isenberg v. Sherman*, 212 Cal. 454, 461; 298 Pac. 1004. On March 16, 1926 a decision comprising Findings of Fact and Conclusions of Law was filed, and on January 31, 1927, judgment [50] was entered for the defendants and against the complainants.”

Mr. Atherton: No objection.

Mr. Wild: "XV. An appeal was perfected by the plaintiffs in the aforesaid equity suit (the California Case) to the Supreme Court of the State of California, where further hearings and arguments were had in the matter on appeal, and on April 30, 1931, the California Supreme Court rendered its opinion affirming the judgment of the trial court. The opinion of the Supreme Court of California is reported in 212 Cal. 454, 298 Pac. 1004. On May 28, 1931, the Supreme Court of California denied a petition for rehearing filed by the Hackfeld plaintiffs. The opinion of the Supreme Court of California denying this petition for rehearing is reported in 212 Cal. 507, 299 Pac. 528. Thereafter a motion to recall the remittitur issued to the County Clerk of San Francisco was filed by the complainants on August 26, 1931, and the Supreme Court of California in a decision handed down on January 29, 1932, denied complainants' motion to recall the remittitur. The decision of the Supreme Court of California giving a reason for the denial of the motion to recall the remittitur is reported in 214 Cal. 722, 7 P. 2d 1006. On April 25, 1932, the Supreme Court of the United States denied a petition filed by the Hackfeld plaintiffs for writ of certiorari to the Supreme Court of California, 286 U. S. 547."

Mr. Atherton: No objection. [51]

Mr. Wild: Your Honor, I take it that the Court

will take judicial knowledge of the opinions of the Appellate Court of the State and it won't be necessary to offer them as being considered in evidence for the purposes necessary, either for Government counsel or myself. I take it the Court will take judicial knowledge of them.

The Court: Yes.

Mr. Wild: "XVI. The Court in the aforesaid decision. . . ."

The Court: Well, is it necessary to read all that?

Mr. Wild: No, your Honor.

The Court: Is there any objection to the admission of that?

Mr. Atherton: The Government interposes the same objection, your Honor, to the text of these paragraphs as it did to the original introduction of the findings of fact.

The Court: As immaterial and irrelevant?

Mr. Atherton: Same reasons.

The Court: Overruled.

Mr. Atherton: I'd like the record to show that the Government notes an exception to the ruling.

Mr. Wild: And the same in this paragraph XVI; there are a number of findings which your Honor will read and you don't need now. "No. XVII. American Factors, Limited, paid from time to time all of the expenses of the Hackfeld litigation which totaled \$568,607.76; that these payments were [52] carried by American Factors, Limited on its records as deferred items. The amounts . . ."

The Court: What is meant by that?

Mr. Wild: That is that they weren't liable for them at that time. They were merely making payments and the question on a deferred item as to whether it is an expense or charge is withheld until later. In other words, it is a deferred item.

The Court: As it paid that out, the entry would go through their cash book? And what would it be in the ledger?

Mr. Wild: Well, it would be Hackfeld litigation expense, and it is deferred expense, and then it was billed out to the other defendants right away.

The Court: Oh, yes.

Mr. Wild: If I will read the rest of the paragraph I think it will explain it. Actually there, your Honor, these defendants go into an agreement where Factors would handle the money and they would get it into Factors under that other agreement, and then it all was held in suspense to await the final determination of the litigation.

Mr. Atherton: Excuse me a minute. Would you like to correct that statement? I don't think it is altogether accurate, Mr. Wild. The stipulation says the amounts were paid.

Mr. Wild: That's right. [53]

Mr. Atherton: As far as American Factors were concerned, for bookkeeping purposes it carried the amount despite their payment in a suspense account.

Mr. Wild: That's right.

Mr. Atherton: But I'm afraid that your statement, if the reporter will read it back, maybe gave the erroneous impression that they were not to be paid ultimately.



Mr. Wild: Under the agreement they were paid as they currently went along, but they were carried to suspense because of the agreement of the other parties, already in evidence, that they were going to pay all expenses and litigation expenses, and as these expenses were collected or amounts were paid, the parties who signed that agreement were billed for them, and they reimbursed the American Factors. We will go right on with the stipulation, and it will explain it.

Mr. Atherton: I just want it clear.

Mr. Wild: "The amounts so paid and the years in which payment thereof were made were as follows:"

And then there is a tabulation which shows the years.

The Court: Yes, I have looked at that. Now, I would have thought that it would be more understandable to have shown the account as going directly from the account books of the American Factors than to have compiled this statement.

Mr. Wild: Well, these statements, I might say, came [54] from Government counsel, and they came also from data which we had furnished. And we have those other statements which will be adduced in evidence, your Honor.

The Court: All right.

Mr. Wild: And this stipulation, as I understood it, was to have before your Honor, at your hands, a memorandum of the thing.

The Court: All right.

Mr. Wild: I have here, I might say, a summary of the accounts and a summary of the accounts as shown in the books, and a summary that shows these other payments in the years in which they were made, which I promised counsel for the Government I am going to adduce in evidence here, your Honor.

“During the early period of the Hackfeld litigation \$396,812.50 of the above expenses was prorated among twenty-two of the Hackfeld co-defendants in proportion to their shareholdings in American Factors, Limited, as shown below, pursuant to the agreement signed by defendants other than American Factors, Limited, a copy of which, marked Exhibit 1, is annexed hereto and made a part hereof, and the taxpayer collected from these stockholders at the times shown below the amounts stated opposite their names, to wit:”.

And then comes a list which I don't need to read, I take it, of the items which were billed and collected in 1924, '25——

The Court: Well, wasn't there a couple of those signers [55] of the agreement who died and are not included in this?

Mr. Wild: Yes, your Honor.

The Court: Were collections made from them?

Mr. Wild: I don't—just a second—there may have been one.

The Court: Their estates would have been liable for it.

Mr. Wild: Well, your Honor, for anyone who signed the agreement—you see, there were certain ones that had died between the reorganization of American Factors and the threatened litigation, and didn't sign the agreement. Of those who signed the agreement——

The Court: All paid?

Mr. Wild: ——all paid. So that under that agreement—as your Honor remembers, all the expenses of the litigation that the so-called steering committee approved or adopted were all to be paid by them. And that was done. So I don't need to repeat this. It shows the amounts in December, 1924, August '25, December and January '26. And it shows that they were billed by American Factors during these periods of time with items that totaled \$396,812.50 on account of Hackfeld litigation expenses. One time the American Factors had on hand more money than had been incurred for expenses or had been paid, been billed for expenses at that time.

“In the year 1932 after the conclusion of the Hackfeld [56] litigation, the taxpayer repaid to the above-named stockholders . . .” That is, the taxpayer should mean American Factors, Limited. “. . . repaid to the above-named stockholders, except S. W. Wilcox who had died in the meantime, the amounts previously collected from them. Taxpayer repaid in 1932 to the heirs of S. W. Wilcox, deceased, the amounts stated opposite their names, to wit:”.

Now, it shows that S. W. Wilcox in the first table had paid in \$16,187.50, and the reimbursement to his payers was \$16,187.50,—

The Court: Yes.

Mr. Wild: "Repayment of the \$396,812.50 was authorized by a resolution adopted by the board of directors of the taxpayer at a meeting thereof held on March 4, 1932. A true copy of an excerpt from the minutes of the annual meeting of the stockholders of American Factors, Limited, held March 4th, 1932 containing that resolution is annexed as Exhibit 2 and made a part hereof."

Mr. Atherton: Your Honor, I'd like to ask the reporter to read the statement by Mr. Wild that preceded his reading of this paragraph at the bottom of page 15. I move that that statement be stricken. It purports to be a statement of fact.

The Court: Well, I would take the offhand view that that is a part of the opening statement. [57]

Mr. Wild: Yes, your Honor.

The Court: And that is something that he would expect to prove later.

Mr. Wild: That is it, your Honor. I merely made it because I understood it was an answer to your Honor's inquiry.

Mr. Atherton: Well, if it is admitted for that limited purpose, very well, your Honor. I will withdraw my objection.

The Court: Let the record show that.

Mr. Atherton: No objection to that paragraph.

The Court: This shows that the stockholders'

meeting of March 4th passed a resolution annexed as Exhibit 2, March 4th, that it was before the Supreme Court of the United States, that they denied certiorari?

Mr. Wild: That is right. It was after——

The Court: Let's see this Exhibit 2. Where is it?

Mr. Wild: Shall I read that?

“Excerpt from Minutes of Annual Meeting of Stockholders of American Factors, Limited, Held March 4th, 1932.

‘President Bottomley addressed the stockholders as follows:

“I should like to refer to the paragraph in my report which deals with the case of Isenberg et al. versus Sherman et al., or the so-called Hackfeld litigation, the expenses of which have been advanced by certain [58] of the individual defendants pending the decision of the Court as to whether their acts were legal and the transaction a valid one. These defendants, as officers and large stockholders, participated in the organization of American Factors, Limited, and were made co-defendants with American Factors, Limited, in the litigation.

“The litigation in California, as you all know, complained of the acts of these individual defendants, as well as the acts of American Factors, Limited, in connection with the reorganization of Hackfeld & Co. and the organization of American Factors, Limited, and the suit brought in New York asked the Court to rescind the entire transaction and to charge upon the assets of American Factors,



Limited, the claims of the plaintiffs to an amount of \$10,000,000 and upwards.

“The claims made in these two suits show beyond any possibility of doubt that the whole structure on which American Factors, Limited, was founded was attacked by this litigation and that the defendants in the suit were attacked solely because they had assisted in the formation of American Factors, Limited. Accordingly, I recommend to this meeting of Stockholders that they approve of the payment by the Company of the litigation expenses rather than have them remain as a charge [59] against those who, under the direction of the Alien Property Custodian, were responsible for the formation of your Company.

“The Undivided Profits and Reserves of Hackfeld & Co. standing on the books of that Company as of August 18th, 1918, the date on which Hackfeld & Co. was taken over by the American Factors, Limited, were set aside as a reserve to meet any contingent claims on American Factors, Limited, or unknown liabilities of Hackfeld & Co., and I believe that the balance of this reserve could justly and properly now be used in the payment of these expenses so that the actual earnings of the Company would not be affected thereby.”

President Bottomley stated further that this matter was taken up with Mr. Oscar Sutro, attorney for the Company during the litigation, and that he feels that the whole structure of the Company was involved in the claims made by Mr. Nylen and

that the litigation expenses should be paid by the Company.

An opinion of Messrs. Smith, Wild and Beebe, attorneys for the Company on this subject, dated March 3rd, 1932, which opinion is filed with the records of the Secretary of the Company and made a part of these minutes, was then read to the Stockholders, this opinion reciting the view of the attorneys that it is within the powers [60] of the corporation to make reimbursement to the individual defendants in the Hackfeld Litigation, and, further, that the corporation is under moral obligation to make such reimbursement upon proper authorization of the Stockholders.

Mr. W. F. Frear thereupon offered and moved the following resolution, to wit:

Resolved: That the officers of this corporation be and they are hereby authorized and directed to pay on behalf of the corporation the costs and expenses of the litigation known as the Hackfeld litigation in the courts of Hawaii, San Francisco, New York and elsewhere.

'The motion for the adoption of the resolution was seconded by Mr. F. L. Bellows and unanimously carried and the resolution thereby duly adopted.' "

Mr. Atherton: The Government objects to the introduction of that exhibit on the basis that it is hearsay, incompetent, irrelevant and immaterial. And the only thing that the Government would not object to is that the refund amount of the \$396,000 was duly authorized by the board of directors on that date.

The Court: Well, you think there is other matter in this resolution that shouldn't be put in as evidence?

Mr. Atherton: I believe so, your Honor.

The Court: Merely the substantial fact that the stockholders [61] had a meeting, and at a meeting at this time did authorize a refund?

Mr. Atherton: That is all that is material and relevant here. Now, if counsel wants to offer in evidence the opinion rendered to the tax payer, why, I have no objection to that going in.

Mr. Wild: I must confess, your Honor, counsel for the Government asked me to get this record, asked me to attach it to the stipulation. I told him I'd have our letter here. I put in exactly what he wanted. And I am surprised now that he has made any objection to it. I told him that I'd have our letter to present. It seems to me it is all part of the *Res gestae*, your Honor, clearly.

The Court: The objection is noted and overruled.

Mr. Atherton: Exception, your Honor.

Mr. Wild: I was surprised. Then the next paragraph:

"XVIII. In its federal income tax return for the taxable year 1932, the taxpayer took the entire amount of \$568,607.76 of Hackfeld litigation expenses as a deduction in computing its taxable net income, and the Commissioner of Internal Revenue disallowed the entire amount claimed as a deduction."

Mr. Atherton: No objection.

Mr. Wild: May we offer stipulation No. 2 in evidence? I think that would be P-5, your Honor.

The Court: Well, it has already been read and it is attached to this stipulation, and as I remember, the stipulation was offered in evidence.

Mr. Wild: Yes, your Honor.

The Court: And it is now accepted in evidence subject to the objections heretofore made and as ruled on with the exceptions reserved.

Mr. Atherton: I'd also like to ask your Honor that the record show that in accepting it in evidence over the Government's objections heretofore made, that the admissibility be limited to the statements literally made in the stipulation of facts and the documents annexed thereto, and not those supplemented by counsel.

The Court: Well, that would follow as a matter of course. The transcript of the proceedings here, in connection with the reading, would show perhaps many extraneous remarks. What do you want this numbered as, this stipulation?

Mr. Wild: I think that would be P-5, your Honor. According to my record that would be the fifth exhibit.

The Court: The stipulation is No. 2?

Mr. Wild: Two.

The Court: As qualified by earlier statements of the Court, accepted in evidence as Exhibit P-5.

(The document referred to was received in evidence as Plaintiff's Exhibit P-5.) [63]

## PLAINTIFF'S EXHIBIT P-5

(Admitted)

In the United States District Court for the  
Territory of Hawaii

Civil Action No. 419

AMERICAN FACTORS, LIMITED, a Hawaiian  
Corporation,

Plaintiff,

vs.

AGNES M. KANNE, Executrix Under the Will  
and of the Estate of Fred H. Kanne, Collector  
of Internal Revenue of the United States for  
the District of Hawaii,

Defendant.

## STIPULATION II

SMITH, WILD, BEEBE & CADES.  
U. E. WILD,

Attorneys for Plaintiff.

LELAND T. ATHERTON,  
Special Assistant to the  
Attorney General,  
Tax Division,  
Department of Justice,  
Washington, D. C.,

Attorney for the Defendant.



## Plaintiff's Exhibit P-5—(Continued)

It is hereby stipulated by and between the parties hereto through their respective attorneys that the following statements of fact shall be considered as true, and that either party may offer in evidence, oral testimony or any additional evidence, documentary or otherwise not inconsistent with the facts herein stipulated.

## I.

When the United States entered the First World War, H. Hackfeld & Company, Limited, (hereinafter referred to as "Hackfeld Co.") was an Hawaiian corporation, which was then conducting and had conducted for many years prior thereto a sugar plantation agency, general merchandise store and other businesses and was a large factor in the Hawaiian sugar industry and in other businesses in the Territory of Hawaii; that Hackfeld Co. had been and was at that time controlled by German interests; that on or about January 28, 1918, and during March, 1918, the Alien Property Custodian of the United States seized the stock of Hackfeld Co., owned by German Nationals and gained control either directly or indirectly of approximately Sixty-eight and one-half ( $68\frac{1}{2}$ ) per cent of its capital stock.

## II.

Prior to January 28, 1918, the business of Hackfeld Co., had been seriously disrupted as a consequence of restrictions placed upon it by the Al-

## Plaintiff's Exhibit P-5—(Continued)

lied Governments as the result of its German affiliations and those of its stockholders. A plan for the reorganization of said company was formulated in the office of the Alien Property Custodian of the United States of America, (hereinafter referred to as "Alien Property Custodian"), which plan as thereafter perfected is fully set forth in a resolution adopted by the stockholders of that company on July 19, 1918, a copy of which is attached to the Answer of the Defendants, Respondents (exclusive of the Alien Property Custodian) filed in *Isenberg et al., Plaintiffs, Complainants v. George Sherman et al., Defendants, Respondents*, being No. 149913 Dept. No. 2 in the Superior Court of the State of California, in and for the City and County of San Francisco, (hereinafter referred to as the "California Case") as Exhibit A thereof.

## III.

In the decision filed on March 16, 1926, in the California Case referred to in Paragraph II *supra*, the Court in its Findings of Fact found in part as follows:

## "VIII.

The organization of American Factors, Limited, as a new corporation to take over the business and assets of H. Hackfeld & Co., Ltd., as a going concern and whose stock, or trust certificates therefor, was to be sold to American citizens, was an integral part of said plan.

## Plaintiff's Exhibit P-5—(Continued)

“X.

It was the opinion of the Alien Property Custodian at all times after the seizure of said stock that the sale of the business and assets of H. Hackfeld & Co., Ltd., as a going concern and the preservation and continuance of its business rather than its disintegration were for the best interests of the stockholders of said corporation. He was also of the opinion and so determined that the best interests of the public and the proper administration of the Trading with the Enemy Act required such preservation and continuance of said business.

“XI.

It was the opinion and judgment of the Alien Property Custodian that it was necessary for the continued welfare and prosperity of said business and to public confidence in said business and to the successful consummation of his plan for its reorganization, that persons in Honolulu who were conversant with business of a similar nature should assume its direction. Such opinion and judgment were reasonable and proper. The defendants named in paragraph XX\* of the complaint, other than the defendants H. L. Scott, Richard H. Trent and Trent Trust Company, Ltd., organized a joint subscription, substantially all the joint subscribers to which were known to and reported to the Alien Property Custodian, for the purchase of at least

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\*Consisting of 23 persons and corporations.

## Plaintiff's Exhibit P-5—(Continued)

one-half of the stock of the American Factors, Ltd., to the end that they might control and direct said American Factors, Ltd., in continuing the business of H. Hackfeld & Co., Ltd., and retain the agencies theretofore held by it, and so that the public invited to subscribe to the stock of American Factors, Ltd., might do so in reliance upon the management of said business by representatives of corporations conversant with and theretofore highly successful in similar business, and to the end that said public having so subscribed, should be protected in its investment.

\* \* \*

About 637 persons subscribed to and became stockholders of American Factors, Ltd.

\* \* \*

## “XXXIV.

Long prior to the meeting of July 19th, 1918, the Alien Property Custodian was advised that the defendants, Castle & Cooke, Limited, Alexander & Baldwin, Limited, Matson Navigation Company, C. Brewer & Company, Limited, Welch & Company, J. B. Atherton Estate, Limited, Henry P. Baldwin, Limited, Charles M. Cooke, Limited, G. N. Wilcox, S. W. Wilcox, A. S. Wilcox, Wallace M. Alexander, George Sherman, J. F. Lowrey, F. C. Atherton, R. A. Cooke, and others, proposed to purchase more than one-half of the stock proposed to be issued by the new corporation which was to suc-

## Plaintiff's Exhibit P-5—(Continued)

ceed to the business of H. Hackfeld & Co., Ltd. The Alien Property Custodian was well acquainted with the identity and business connections of said defendants whose names were furnished to him.

It was the aim and purpose of the Alien Property Custodian, stated and believed by him to be for the best interests of said corporation and its stockholders, and it was in fact to the best interests of said corporation and its stockholders, that a large portion of the trust certificates mentioned in said stockholders' resolution of July 19, 1918, should be purchased by persons familiar with the sugar agency business in the Hawaiian Islands, and by persons who could properly and efficiently manage said business, and in whom the subscribing public would have confidence. To that end it was the desire of the Alien Property Custodian and his plan, that a large portion of said trust certificates should be purchased by those persons and corporations who were then engaged in the plantation agency business in Hawaii.

It was the purpose of the Alien Property Custodian to induce the defendant firms who were then engaged in the sugar agency business, to subscribe to said trust certificates in order to insure the success and continuance of the business of H. Hackfeld & Co., Ltd., or the successor corporation to be formed. It was believed by the Alien Property Custodian that in that manner he could best secure the prosperity of the corporation which was



## Plaintiff's Exhibit P-5—(Continued)

to take over the business and assets of H. Hackfeld & Co., Ltd., under said plan adopted by the stockholders of H. Hackfeld & Co., Ltd., on July 19th, 1918. It was the opinion of the Alien Property Custodian that the public of Hawaii would more readily subscribe to the trust certificates to be issued under said plan if the control and management of said successor corporation were in the hands of the defendant firms then engaged in the sugar agency business in the Territory of Hawaii. The opinion and belief of the Alien Property Custodian in these respects were reasonable.

The Alien Property Custodian therefore desired the purchase by said defendants and their associates in this finding first above named and referred to, of a large part of the trust certificates representing the stock of American Factors, Ltd., and acquiesced in the allotment to said defendant firms and their associates upon their subscriptions of one-half of said trust certificates."

## IV.

The subscription for trust certificates for shares of American Factors, Ltd., is attached to the Answer filed in the California case as Exhibits B and C thereof and shows that the participants subscribed to a total of twenty-seven thousand (27,000) shares of stock in blocks of stock, ranging from one hundred (100) to two thousand five hundred (2,500) shares, conditioned upon the allotment of a mini-

## Plaintiff's Exhibit P-5—(Continued)

mun of twenty-five thousand (25,000) shares to the group; that the joint subscription agreement was accepted for a total of twenty-five thousand (25,000) shares and trust certificates were issued to and paid for by the said signers of the said joint subscription agreement for the total of said twenty-five thousand (25,000) shares; that trust certificates, representing the other twenty-five thousand (25,000) shares of the Plaintiff's capital stock were allotted to and paid for by approximately six hundred and fourteen (614) other persons and corporations.

## V.

That trust certificates, representing fifty thousand (50,000) shares of the capital stock of Plaintiff, were issued and sold for the price of one hundred and fifty dollars (\$150.00) per share and the total stated consideration of seven million, five hundred thousand dollars (\$7,500,000.00) was duly paid in cash or United States Liberty Bonds at par to Hackfeld Co., and in exchange therefor Hackfeld Co., conveyed all of its assets and businesses as a going concern on August 20, 1918 to the Plaintiff and Plaintiff assumed all liabilities of Hackfeld Co. and of the business, and Plaintiff thereafter continued the business as a going concern.

## VI.

That included among the subscribers participating in the joint subscription agreement were persons who were incorporators of American Factors,

## Plaintiff's Exhibit P-5—(Continued)

Limited, and persons who subsequently became officers and directors of that corporation or of Hackfeld Co., or who otherwise participated in the business and affairs of Plaintiff.

## VII.

That about June 1924, the then directors of American Factors, Limited were informed that former stockholders of Hackfeld Co., then dissolved, threatened to initiate litigation; that at that time it was not known what form the litigation would take nor who would be the Defendants; that the Board of Directors of American Factors, Limited, after consideration, authorized its president to secure counsel for American Factors, Limited, to prepare for and to conduct the defense in the threatened litigation; that American Factors, Limited procured the services of attorneys to represent it in the threatened litigation.

## VIII.

Prior to the filing of the suits in the threatened litigation above mentioned, twenty-one of the twenty-three persons and corporations who had joined in the joint subscription agreement for the shares of stock of American Factors, Limited, described in paragraph IV of this stipulation, entered into a written agreement under date of July 28, 1924, a true copy of which is annexed hereto as Exhibit 1 and made a part hereof, wherein they agreed to prorate on an original per share basis the

## Plaintiff's Exhibit P-5—(Continued)

expenses of the aforesaid threatened litigation if they were joined as defendants therein. Two of the individuals who had joined in the joint subscription agreement hereinbefore described did not participate in the agreement of July 28, 1924, to share the expenses of the threatened litigation because they had died. American Factors, Limited was not a party to the agreement of July 28, 1924.

## IX.

That the suit of J. C. Isenberg, et al., Plaintiffs, Complainants, hereinafter called "Hackfeld Plaintiffs" v. George Sherman . . . American Factors, Limited, et al., Defendants, Respondents, hereinafter called "Hackfeld Defendants", and which litigation, hereinafter called the "Hackfeld litigation", was commenced in August and September 1924; that identical complaints in the Hackfeld litigation were filed in the Circuit Court of the First Judicial Circuit, Territory of Hawaii, and in the Superior Court of the State of California in and for the City and County of San Francisco; that by stipulation between the parties the case filed in the California court was tried; that American Factors, Limited was one of the defendants named in the Hackfeld litigation and the twenty-three corporations and persons, including the representatives of the estates of the two deceased persons who had signed the joint subscription agreement, were joined as Hackfeld Defendants.

## Plaintiff's Exhibit P-5—(Continued)

## X.

The Supreme Court of California, as reported in 212 Cal. 454, 461; 298 Pac. 1004 at page 1006, said of the aforesaid complaint:

“ . . . The purport of the complaint is to require the individual and corporate respondents to account to complainants for all matters and things concerning the transfer and sale of the assets of H. Hackfeld & Company, Limited, to American Factors, Limited, an Hawaiian corporation, organized for the express purpose of taking over the business and assets of said H. Hackfeld & Company Limited. The gist of the complaint affirms the sale and alleges that the sale and transfer were the result of conspiracy, collusion, and fraudulent connivance on the part of certain of the respondents, whereby they secured the assets and profitable business of H. Hackfeld & Company, Limited, at a price far below its alleged intrinsic value, in fraud of and to the financial injury of complainants. The object of the suit is to require respondents to account to complainants for the transfer and sale of the assets of H. Hackfeld & Company, Limited, to American Factors, Limited, and to account for the difference between \$7,500,000, the price at which the assets were sold, and the actual value of the assets of the corporation at the date of transfer, which appellants claim to be \$17,500,000. The Alien Property Custodian of the United States was made a respondent, but no relief or judgment is sought against him,



## Plaintiff's Exhibit P-5—(Continued)

it being alleged that his interest as trustee for certain of the stockholders 'is identical with the interest of the complainants herein,' but not having joined as a complainant, he is joined as a respondent, so that, as such trustee, he may properly receive the benefits of any judgment which may be entered herein.' Certain other persons are made formal respondents for the same reasons."

## XI.

That the complaint in the aforesaid action, in Paragraph XXXVI thereof, in substance, alleged that American Factors, Limited took and received all of the assets of Hackfeld Co., with full knowledge of all the facts and circumstances set forth in the complaint, and with full knowledge of and concerning the rights and equities of the stockholders of said Hackfeld Co., and did thereafter handle the said assets and conduct said business in trust for the protection by it of the rights and equities of said stockholders and the complainants, and said American Factors, Limited did so mismanage said business and did so improperly handle said assets as to cause great damage to said assets and business and great injury to the rights and equities of said stockholders and complainants, and that the American Factors, Limited was a party to the fraudulent scheme and the conspiracy therein alleged, and holds said business and said property in trust to protect the rights and equities of com-

## Plaintiff's Exhibit P-5—(Continued)

plainants, and that by its mismanagement of said business and said assets, it has caused further and additional loss to said business and to said stockholders of said Hackfeld Co., and to the complainants in the sum of upwards of Two and One-Half Million Dollars in addition to all other damage and loss suffered by complainants.

## XII.

The prayers in the above referred to complaint, among others, included the following:

“8. That this Court do make and enter its order ordering and directing the Respondents A. W. T. Bottomley, R. A. Cooke, C. R. Hemenway, G. P. Wilcox, F. C. Atherton, F. J. Lowrey, R. H. Trent and George Sherman, to make a full and complete accounting of and concerning all matters and things having to do with their doings as officers and directors of American Factors, Ltd., and as such as fiduciaries of the rights and equities of Complainants herein, in and attaching to the assets and business of said corporation, as more fully hereinabove set forth;

9. That this Court do make and enter its order ordering and directing the Respondent American Factors, Ltd., that it do hold that part and portion of the assets and business belonging to it, said American Factors, Ltd., and representing the interest in said corporation of the Respondents named in paragraph XX of this Bill of Complaint in trust

## Plaintiff's Exhibit P-5—(Continued)

for Complainants herein, subject to the application of said assets to the satisfaction of such judgment as may be entered herein against said Respondents in this paragraph of Complainant's prayer hereinabove named and referred to. And that it do hold all of its said assets subject to their application to such judgment as may be rendered herein against it, said Respondent American Factors, Ltd.;

10. That this Court do make and enter its order ordering and directing Respondents named in paragraph XX of this Bill of Complaint, that they, said Respondents, do hold the stock of American Factors, Ltd., purchased and held by them as more fully hereinabove set forth in trust for Complainants herein, subject to the application of said stock to the payment of such judgment as may be entered herein against said Respondents named in paragraph XX of this Bill of Complaint;

\* \* \* \*

12. That this Court do make and enter its judgment against the Respondents named in paragraph XX of this Bill of Complaint, and against the Respondent American Factors, Ltd., and in favor of the Complainants in such manner as to the Court may seem just and proper and for such an amount as will adequately and completely compensate and reimburse said Complainants for the injury, loss and damage suffered by them, said Complainants, by rea-

## Plaintiff's Exhibit P-5—(Continued)

son of the fraud perpetrated by said Respondents as more fully hereinabove set forth;

\* \* \* \*

19. That this Court do make and enter its judgment against the Respondents A. W. T. Bottomley, R. A. Cooke, C. R. Hemenway, G. P. Wilcox, F. C. Atherton, F. J. Lowrey, R. H. Trent and George Sherman on an accounting to be made by said Respondents as officers and directors of American Factors, Ltd., and as fiduciaries to protect the rights and equities of Complainants herein in and attaching to the assets and properties of said corporation, for such an amount as it may appear that Complainants have been injured by reason of the mismanagement and breaches of trust committed by said Respondents as said fiduciaries;

20. That this Court do make and enter its judgment against the Respondent American Factors, Ltd., for such an amount as it may appear that Complainants have been injured by reason of injury to their equities and rights attaching to the properties of said corporation through mismanagement and breach of fiduciary duty committed by said Respondent corporation."

## XIII.

That the attorneys employed by American Factors, Limited investigated the facts and matters pertaining to the Hackfeld litigation and prepared

## Plaintiff's Exhibit P-5—(Continued)

a joint answer on behalf of American Factors, Limited and the other Hackfeld Defendants, except the Alien Property Custodian and the nominal Defendants and signed and filed the answer on behalf of such Hackfeld Defendants. A separate answer was filed on behalf of the Alien Property Custodian.

## XIV.

The trial judge filed the following memorandum on January 6, 1926:

"I am of the opinion that (1) no actual fraud on the part of respondents was shown; (2) no constructive fraud existed; (3) the price paid was adequate; (4) the suit is not barred by the Hawaiian statute of limitations; (5) plaintiffs were not guilty of laches. Frank J. Murasky, Judge."

The trial judge's memorandum quoted above is taken from the report of the Supreme Court of California in the case of *Isenberg v. Sherman*, 212 Cal. 454, 461; 298 Pac. 1004. On March 16, 1926 a decision comprising Findings of Fact and Conclusions of Law was filed, and on January 31, 1927, judgment was entered for the defendants and against the complainants.

## XV.

An appeal was perfected by the plaintiffs in the aforesaid equity suit (the California Case) to the Supreme Court of the State of California, where further hearings and arguments were had in the



## Plaintiff's Exhibit P-5—(Continued)

matter on appeal, and on April 30, 1931, the California Supreme Court rendered its opinion affirming the judgment of the trial court. The opinion of the Supreme Court of California is reported in 212 Cal. 454, 298 Pac. 1004. On May 28, 1931, the Supreme Court of California denied a petition for rehearing filed by the Hackfeld plaintiffs. The opinion of the Supreme Court of California denying this petition for rehearing is reported in 212 Cal. 507, 299 Pac. 528. Thereafter a motion to recall the remittitur issued to the County Clerk of San Francisco was filed by the complainants on August 26, 1931, and the Supreme Court of California in a decision handed down on January 29, 1932, denied complainants' motion to recall the remittitur. The decision of the Supreme Court of California giving a reason for the denial of the motion to recall the remittitur is reported in 214 Cal. 722, 7 P. 2d 1006. On April 25, 1932, the Supreme Court of the United States denied a petition filed by the Hackfeld plaintiffs for writ of certiorari to the Supreme Court of California, 286 U.S. 547.

## XVI.

The Court in the aforesaid decision filed on March 16, 1926, among others, made the following findings of fact:

## “XL.

On July 19, 1918, August 20, 1918, and at all times during the year 1918, the entire net assets and busi-

## Plaintiff's Exhibit P-5—(Continued)

ness of H. Hackfeld & Co., Ltd., whether as a going concern or by way of liquidation or otherwise, were worth no more than the amount realized from the sales pursuant to the stockholders' resolution of July 19, 1918, of the trust certificates therein mentioned. Neither the entire capital stock of American Factors, Ltd., nor all said trustees' certificates were worth at the time they were sold pursuant to said resolution or at any time prior to their sale, more than was actually received therefor, to wit, \$7,500,000, which was paid partly in cash and partly in bonds of the United States and in accordance with said resolution.

The 50,000 fully paid shares of stock of American Factors, Ltd., mentioned in said stockholders resolution and subject to all the terms and conditions thereof, were at the time that they were issued to H. Hackfeld & Co., Ltd., in exchange for the property in this finding referred to, an adequate, just and fair price to H. Hackfeld & Co., Ltd., for all and singular the property, business, rights, contracts, agencies, franchises, credits, accounts and other interests of every kind of said H. Hackfeld & Co., Ltd., and the good will thereof as a going concern, subject to its outstanding debts, obligations and liabilities, including income taxes for the year 1918 up to the date of transfer of said property, etc., to said American Factors, Ltd.

The price of \$150. per share, payable partly in cash and partly in Liberty Bonds as provided in

## Plaintiff's Exhibit P-5—(Continued)

said stockholders' resolution and at which trust certificates representing stock of American Factors, Ltd., were sold, was an adequate price, and was a just and fair price for said trust certificates and for said stock and for the business and assets of H. Hackfeld & Co., Ltd. It is also the fact that a higher price could not have been obtained for the said assets and business of H. Hackfeld & Co., Ltd., or for the stock of H. Hackfeld & Co., Ltd., or of American Factors, Ltd., or for the trust certificates, than the price that was actually realized.

Each and every person who was a stockholder of H. Hackfeld & Co., Ltd., on July 19, 1918, has received by way of distributions from the proceeds of the trust certificates representing stock of American Factors, Ltd., sold pursuant to said stockholders' resolution of July 19, 1918, a just, fair and adequate price for his respective shares of stock in H. Hackfeld & Co., Ltd., owned by him on July 19, 1918, to wit in excess of \$194.50 for each share of common stock and \$100. plus accrued dividends for each share of preferred stock.

H. Hackfeld & Co., Ltd., did not at any time in the year 1918 or thereafter own property, real and personal, in the Territory of Hawaii, or elsewhere, which with or without the business of said corporation was of the value of upwards of \$17,500,000, or of any value which after deducting the liabilities of said corporation was in excess of the price herein

## Plaintiff's Exhibit P-5—(Continued)

found to have been a fair and just price for the business and assets of said corporation.

\* \* \* \*

## XLIV.

None of the plaintiffs whose stock in H. Hackfeld & Co., Ltd., had not been seized by the Alien Property Custodian was paid any other consideration than cash in the liquidation of the stock of said corporation. The Liberty Bonds paid for said trust certificates were, with the consent of the Alien Property Custodian, turned over to the Alien Property Custodian at par in payment and liquidation of the stock of H. Hackfeld & Co., Ltd., theretofore seized by him.

## XLV.

The defendants did not, nor did any of them, reap any benefits from said reorganization or from the sale of said stock of American Factors, Ltd., or the trust certificates therefor, or from the purchase thereof by themselves except such benefits as accrued to every purchaser of said trust certificates.

\* \* \* \*

## L.

American Factors, Ltd., received the business and assets of H. Hackfeld & Co., Ltd., and issued in exchange therefor its entire authorized capital stock, consisting of 50,000 shares, which was received by H. Hackfeld & Co., Ltd., in full payment for said

## Plaintiff's Exhibit P-5—(Continued)

business and assets in accordance with said resolution of the stockholders of H. Hackfeld & Co., Ltd., adopted July 19, 1918.

Pursuant to said resolution the trust certificates issued for the American Factors, Ltd., stock were in the month of July, 1924 duly exchanged for stock of American Factors, Ltd.”

## XVII.

American Factors, Limited, paid from time to time all of the expenses of the Hackfeld litigation which totaled \$568,607.76; that these payments were carried by American Factors, Limited on its records as deferred items. The amounts so paid and the years in which payment thereof were made were as follows:

Year Paid	Amount Paid
1924.....	\$108,450.65
1925.....	198,114.32
1926.....	149,117.30
1927.....	6,255.49
1928.....	12.27
1929.....	15,852.83
1930.....	(1,707.28)*
1931.....	4,519.68
1932.....	87,992.50
	<hr/> \$568,607.76

During the early period of the Hackfeld litigation \$396,812.50 of the above expenses was prorated among twenty-two of the Hackfeld co-defendants in

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\* this amount reflects a fee of \$2,539.28 charged in error December 24, 1929.



## Plaintiff's Exhibit P-5—(Continued)

proportion to their shareholdings in American Factors, Limited, as shown below, pursuant to the agreement signed by defendants other than American Factors, Limited, a copy of which, marked Exhibit 1, is annexed hereto and made a part hereof, and the taxpayer collected from these stockholders at the times shown below the amounts stated opposite their names, to wit:

## Plaintiff's Exhibit P-5—(Continued)

	No. Shares	Dec. 1924	Aug.-Oct. 1925	Dec. & Jan. 1925 1926	Total
C. Brewer & Co. ....	2,300	\$10,350.00	\$ 8,050.00	\$ 21,850.00	\$ 40,250.00
Alexander & Baldwin .....	2,300	10,350.00	8,050.00	21,850.00	40,250.00
H. P. Baldwin, Ltd. ....	2,300	10,350.00	8,050.00	21,850.00	40,250.00
A. W. T. Bottomley .....	1,000	4,500.00	3,500.00	9,500.00	17,500.00
G. P. Wileox .....	500	2,250.00	1,750.00	4,750.00	8,750.00
G. N. Wileox .....	1,850	8,325.00	6,475.00	17,575.00	32,375.00
R. A. Cooke .....	25	112.50	87.50	237.50	437.50
F. J. Lowrey .....	500	2,250.00	1,750.00	4,750.00	8,750.00
C. M. Cooke, Ltd. ....	1,000	4,500.00	3,500.00	9,500.00	17,500.00
E. D. Teeney .....	100	450.00	350.00	950.00	1,750.00
Castle & Cooke .....	2,300	10,350.00	8,050.00	21,850.00	40,250.00
F. C. Atherton .....	250	1,125.00	875.00	2,375.00	4,375.00
J. B. Atherton Estate .....	600	2,700.00	2,100.00	5,700.00	10,500.00
S. W. Wileox .....	925	4,162.50	3,237.50	8,787.50	16,187.50
W. M. Alexander .....	717	.....	5,736.00	6,811.50	12,547.50
Alexander Prop. A/c .....	208	.....	1,664.00	1,976.00	3,640.00
Matson Nav. Co. ....	2,300	.....	18,400.00	21,850.00	40,250.00
W. P. Roth .....	100	.....	800.00	950.00	1,750.00
Andrew Welch .....	100	.....	800.00	950.00	1,750.00
Welch & Co. ....	2,300	.....	18,400.00	21,850.00	40,250.00
George Sherman .....	925	4,162.50	3,237.50	8,787.50	16,187.50
W. F. Dillingham .....	75	.....	600.00	712.50	1,312.50
	22,675	\$75,937.50	\$105,462.50	\$215,412.50	\$396,812.50

## Plaintiff's Exhibit P-5—(Continued)

In the year 1932 after the conclusion of the Hackfeld litigation, the taxpayer repaid to the above-named stockholders, except S. W. Wilcox who had died in the meantime, the amounts previously collected from them. Taxpayer repaid in 1932 to the heirs of S. W. Wilcox, deceased, the amounts stated opposite their names, to wit:

Mrs. S. W. Wilcox .....	\$ 5,395.83
G. P. Wilcox .....	2,158.33
Etta W. Sloggett .....	2,158.33
Elsie H. Wilcox .....	2,158.33
Mabel I. Wilcox .....	2,158.33
Samuel W. Wilcox .....	719.45
Bishop Trust Company, Guardian of Estate of Margaret L. Wilcox .....	719.45
Bishop Trust Company, Guardian Estate of Martha W. Wilcox .....	719.45
	<hr/>
	\$16,187.50

Repayment of the \$396,812.50 was authorized by a resolution adopted by the Board of Directors of the taxpayer at a meeting thereof held on March 4, 1932. A true copy of an excerpt from the minutes of the annual meeting of the stockholders of American Factors, Limited, held March 4th, 1932 containing that resolution is annexed as Exhibit 2 and made a part hereof.

## XVIII.

In its federal income tax return for the taxable year 1932, the taxpayer took the entire amount of \$568,607.76 of Hackfeld litigation expenses as a deduction in computing its taxable net income, and

Plaintiff's Exhibit P-5—(Continued)  
the Commissioner of Internal Revenue disallowed  
the entire amount claimed as a deduction.

SMITH, WILD, BEEBE &  
CADES,

/s/ U. E. WILD,

/s/ MILTON CADES,

Counsel for Plaintiff.

/s/ LELAND T. ATHERTON,

Special Assistant to the Attorney General, Tax  
Division, Department of Justice,

Counsel for Defendant.

/s/ RAY J. O'BRIEN,

United States Attorney for the District of Hawaii,  
Counsel for Defendant.

### Exhibit 1

The undersigned persons and corporations hereby agree each for himself and itself and not for the others of them with Allen W. T. Bottomley, C. R. Hemenway, F. C. Atherton and R. A. Cooke, provided only that he or it is made a party defendant or one of the parties defendant to the suit or suits hereinafter mentioned but not otherwise, to contribute and pay on demand such a proportion of all of the costs and expenses of every description hereinafter mentioned as the number of shares represented by the trust certificates hereinafter mentioned originally subscribed for and issued to them

## Plaintiff's Exhibit P-5—(Continued)

bears to all of the shares represented by all of the said trust certificates subscribed for and issued to all of the subscribers hereto who are made parties defendant to the suit or suits hereinafter mentioned or any of them.

The costs and expenses hereinbefore mentioned are such as the said Allen W. T. Bottomley, C. R. Hemenway, F. C. Atherton and R. A. Cooke or any three of them acting in the name or on behalf of all of them have already paid or incurred or shall or may hereafter pay or incur in or about or in connection with the defense of any suit or suits which may be instituted against the undersigned or any of them upon or pursuant to the notice and demand made by J. F. Neylan as attorney for Mrs. Paul Isenberg and others, dated June 24th, 1924, or by any of the stockholders of H. Hackfeld & Company, Limited, an Hawaiian corporation which has been dissolved or is in process of dissolution by reason of or arising out of either the organization of the American Factors, Limited, or the sale and transfer of the assets of H. Hackfeld & Company, Limited, to the said American Factors, Limited, or the appointment of trustees by H. Hackfeld & Company, Limited, of the whole of the shares of the capital stock of American Factors, Limited; or the sale and issue by the said trustees of trust certificates of shares of the said American Factors, Limited, to sundry persons, firms and



Plaintiff's Exhibit P-5—(Continued)  
 corporations or any of the acts and deeds of the  
 said trustees.

Dated, July 28th, 1924.

(signed)

Alexander & Baldwin, Ltd.

by J. Waterhouse, vice pres. ....2300 shares Cert. #3

Henry P. Baldwin, Ltd.

by J. Waterhouse, Agent .....2300 shares Cert. #34

C. Brewer & Company, Limited.

R. A. Cooke

Vice-President and Manager.....2300 shares Cert. #57

R. A. Cooke..... 25 shares Cert. #113

F. C. Atherton..... 250 shares Cert. #24

J. B. Atherton Estate, Ltd.

F. C. Atherton, Treasurer ..... 600 shares Cert. #26

Castle & Cooke, Ltd.

Chas. H. Atherton, Treasurer .....2300 shares Cert. 79

F. J. Lowery ..... 500 shares Cert. 341

G. Sherman ..... 925 do Ctfs. 493 & 543

Charles M. Cooke, Ltd.

C. H. Cooke, Managing Director.....1000 shares Ctf. #110

Allen W. T. Bottomley.....1000 shares Ctf. #45

G. P. Wilcox..... 500 shares Ctf. #595/6

G. N. Wilcox.....1850 shares Ctf. 597-598

S. W. Wilcox..... 925 shares Ctf. 593/4

Wallace M. Alexander..... 717 shares Ctf. 631

Alexander Properties Co.

By W. M. Alexander, Pres..... 208 shares Ctf. 6

E. D. Tenney ..... 100 shares Ctf. 525

Welch & Co.

J. B. McFarland, Vice President.....2300 shares Ctf. 662

Matson Navigation Company

F. A. Bailey, Secretary.....2300 shares Ctf. 669

W. P. Roth ..... 100 shares Ctf. 656

## Plaintiff's Exhibit P-5—(Continued)

## Exhibit 2

Excerpt from Minutes of Annual Meeting of Stockholders of American Factors, Limited, Held March 4th, 1932

“President Bottomley addressed the stockholders as follows:

‘I should like to refer to the paragraph in my report which deals with the case of Isenberg et al. versus Sherman et al., or the so-called Hackfeld litigation, the expenses of which have been advanced by certain of the individual defendants pending the decision of the Court as to whether their acts were legal and the transaction a valid one. These defendants, as officers and large stockholders, participated in the organization of American Factors, Limited, and were made co-defendants with American Factors, Limited, in the litigation.

‘The litigation in California, as you all know, complained of the acts of these individual defendants, as well as the acts of American Factors, Limited, in connection with the reorganization of Hackfeld & Co. and the organization of American Factors, Limited, and the suit brought in New York asked the Court to rescind the entire transaction and to charge upon the assets of American Factors, Limited, the claims of the plaintiffs to an amount of \$10,000,000 and upwards.

‘The claims made in these two suits show beyond any possibility of doubt that the whole structure on which American Factors, Limited, was founded

## Plaintiff's Exhibit P-5—(Continued)

was attacked by this litigation and that the defendants in the suit were attacked solely because they had assisted in the formation of American Factors, Limited. Accordingly, I recommend to this meeting of Stockholders that they approve of the payment by the Company of the litigation expenses rather than have them remain as a charge against those who, under the direction of the Alien Property Custodian, were responsible for the formation of the Company.

'The Undivided Profits and Reserves of Hackfeld & Co. standing on the books of that Company as of August 18th, 1918, the date on which Hackfeld & Co. was taken over by the American Factors, Limited, were set aside as a reserve to meet any contingent claims on American Factors, Limited, or unknown liabilities of Hackfeld & Co., and I believe that the balance of this reserve could justly and properly now be used in the payment of these expenses so that the actual earnings of the Company would not be affected thereby.'

President Bottomley stated further that this matter was taken up with Mr. Oscar Sutro, attorney for the Company during the litigation, and that he feels that the whole structure of the Company was involved in the claims made by Mr. Nylen and that the litigation expenses should be paid by the Company.

An opinion of Messrs. Smith, Wild and Beebe, attorneys for the Company on this subject, dated March 3rd, 1932, which opinion is filed with the

## Plaintiff's Exhibit P-5—(Continued)

records of the Secretary of the Company and made a part of these minutes, was then read to the Stockholders, this opinion reciting the view of the attorneys that it is within the powers of the corporation to make reimbursement to the individual defendants in the Hackfeld Litigation, and, further, that the corporation is under moral obligation to make such reimbursement upon proper authorization of the Stockholders.

Mr. W. F. Frear thereupon offered and moved the following resolution, to-wit:

Resolved: That the officers of this corporation be and they are hereby authorized and directed to pay on behalf of the corporation the costs and expenses of the litigation known as the Hackfeld litigation in the courts of Hawaii, San Francisco, New York and elsewhere.

The motion for the adoption of the resolution was seconded by Mr. F. L. Bellows and unanimously carried and the resolution thereby duly adopted."

[Endorsed]: Filed December 9, 1949.

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The Court: Now, I think it is about time for a recess.

Mr. Wild: I just have one short offer. I have requested the Government to furnish me with a photostatic copy of the taxpayer's return for the calendar year 1932. It was furnished me this morning, and counsel states to me that it is a photostatic copy of the true return filed.

Mr. Atherton: It is certified.

Mr. Wild: And I would like to offer that certified copy in evidence.

The Court: Let me see that. (Document handed to the Court.)

Mr. Wild: I haven't had a chance to check it. I didn't even see that it was the year 1932. I think it is.

Mr. Atherton: Yes.

The Court: And the return consists of all these separate sheets?

Mr. Wild: Yes, Your Honor. It is the return in the form as prepared by the Government, with schedules attached, all certified, I take it——

Mr. Atherton: Yes.

Mr. Wild: ——as being true and correct copies, the return with the schedules attached.

Mr. Atherton: Yes, the certificate so reads. It is the correct——

The Court: Very well. What will we number that? [64]



Mr. Wild: P-6, Your Honor.

(The document referred to was received in evidence as Plaintiff's Exhibit P-6.)

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PLAINTIFF'S EXHIBIT P-6

Admitted

United States of America

Treasury Department

Washington

May 29, 1940

Pursuant to the provisions of Section 661, Chapter 17, Title 28 of the United States Code (Section 882 of the Revised Statutes of the United States), I hereby certify that the annexed is a true copy of Corporation Income Tax Return for 1932 (with balance sheets and schedules attached), filed by American Factors, Limited, Honolulu, Hawaii, on file in this Department.

In Witness Whereof, I have hereunto set my hand, and caused the seal of the Treasury Department to be affixed, on the day and year first above written.

By direction of the Secretary of the Treasury:

[Seal]      /s/ S. H. MARKS,

Acting Chief Clerk,

Treasury Department.



No. 12391

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United States  
Court of Appeals  
For the Ninth Circuit.

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AGNES M. KANNE, Executrix under the will and of the Estate  
of Fred H. Kanne, Collector of Internal Revenue of the  
United States for the District of Hawaii,

Appellant,

vs.

AMERICAN FACTORS, LIMITED, an Hawaiian Corporation,  
Appellee.

and vs.

AMERICAN FACTORS, LIMITED, an Hawaiian Corporation,  
Appellant,

vs.

AGNES M. KANNE, Executrix under the will and of the Estate  
of Fred H. Kanne, Collector of Internal Revenue of the  
United States for the District of Hawaii,

Appellee.

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Transcript of Record  
In Two Volumes  
Volume II  
(Pages 227 to 622)

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Appeals from the United States District Court,  
District of Hawaii.

FILED

FEB 3 - 1950

PAUL P. O'BRIEN,



No. 12391

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United States  
Court of Appeals  
For the Ninth Circuit.

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AGNES M. KANNE, Executrix under the will and of the Estate  
of Fred H. Kanne, Collector of Internal Revenue of the  
United States for the District of Hawaii,

Appellant,

vs.

AMERICAN FACTORS, LIMITED, an Hawaiian Corporation,  
Appellee.

and vs.

AMERICAN FACTORS, LIMITED, an Hawaiian Corporation,  
Appellant,

vs.

AGNES M. KANNE, Executrix under the will and of the Estate  
of Fred H. Kanne, Collector of Internal Revenue of the  
United States for the District of Hawaii,

Appellee.

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Transcript of Record  
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(Pages 227 to 622)

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Appeals from the United States District Court,  
District of Hawaii.





Mr. Wild: Your Honor said he wanted to recess until what hour?

The Court: I think about two o'clock. Is that satisfactory?

Mr. Atherton: Yes.

The Court: All right.

(The Court recessed at 12:33 p.m.) [65]

### Afternoon Session

(The Court reconvened at 2:00 p.m.)

Mr. Wild: Is Your Honor ready to proceed?

The Court: Yes. We had finished with stipulation No. 2. There was another stipulation.

Mr. Wild: Not in this case, Your Honor. I had thought we would go ahead on the Hackfeld litigation issue first and then later on, when we complete that, later on go into the other stipulation. At this time I would like to make something in the nature of a brief statement of our position.

The Court: Yes.

Mr. Wild: In this connection, hoping that it might be of help to Your Honor, I prepared a preliminary statement of some of the leading authorities, not all, that we relied on. And I also prepared excerpts from the regulations of the U. S. Treasury Department, Bureau of Internal Revenue. Might I state first, Your Honor, that all of the issues arise under the Revenue Act of 1932; that Treasury regulations 77 were issued by the Bureau of Internal Revenue, U. S. Treasury Department, on the Revenue Act of '32.

Now, I have brought up here, if Your Honor would like to have it——

The Court: Is that '32 retroactive, covering the whole year?

Mr. Wild: Yes, Your Honor, for everyone who in the [66] calendar year 1932—it covered the whole of the calendar year 1932.

The Court: This was a tax return for the year '32?

Mr. Wild: Yes, Your Honor.

The Court: Made subsequent to the end of the year?

Mr. Wild: Yes, Your Honor. Now, in case Your Honor would like to have it available, I have the official publication of the Revenue Act which shows the various provisions of it here, and we are discussing now Section 23(a) of the Revenue Act, the ordinary, necessary expenses of business. Now, I have here furnished for you a copy, and I have given counsel, furnish counsel for the Government with a copy of the regulations 77, which I have here. And if Your Honor would like to use it, I'd be glad to have Your Honor use this in consideration of this. The copy here is a copy of what is there.

The Court: Yes, I know about this in a general way, all the ordinary and necessary expenses of a business.

Mr. Wild: Yes, Your Honor.

The Court: Now, that pertains to what part of your complaint?

Mr. Wild: The Hackfeld litigation.

The Court: The Hackfeld litigation, ordinary expenses?

Mr. Wild: Expenses of business, Your Honor. Our contention is, as shown in our memorandum, and also in our [67] complaint on file, that these expenses are ordinary and necessary expenses allowable under the provisions of Section 23(a) of the Revenue Act of 1932. For Your Honor's information, the provisions of the Revenue Act for many years prior thereto and subsequent thereto were the same, so that the Act so far as this provisions is concerned was the same at all times, I think, from the early twenties up to, I think, the present time.

Now, it is our position, Your Honor, that as all of the expenses of the Hackfeld litigation became obligations which the company has between itself and those others charged with fraud had to pay for the first time in the year 1932, that the amount of those obligations is either an ordinary and necessary expense of the carrying on of the business of H. Hackfeld and Company, Limited, or it is a deferred payment for the assets of H. Hackfeld and Company, Limited, which would then be a capital item of the plaintiff, which plaintiff company set-up is a part of its invested capital. We have outlined the facts as some length this morning.

On the precise question as to whether or not this is an ordinary and necessary business expense within the meaning of that law incurred in carrying on a trade or business, we would call Your Honor's attention to the case of Matson Navigation

Company, Petitioner, versus Commissioner Internal Revenue, Respondent. The Matson Navigation Company was one [68] of the parties charged with fraud. As it was billed by American Factors, Matson Navigation Company paid the expenses of litigation. Matson Navigation Company deducted those expenses of litigation as ordinary and necessary business expenses in the conduct of their business within the meaning of the Revenue Act which was identical in verbiage with the '32 Act. That claim was made, Your Honor, before the conclusion of the case and before it was known who would bear the burden. The Government contested the case on the ground that it was not an ordinary and necessary business expense of the Matson Navigation Company and that they were not entitled to deduct it.

The case itself has two errors of fact in the finding, which, as I take it, so far as our case is concerned, are immaterial on that issue of law. The court says: "The second item in controversy on the payment is the payment made to American Factors, Limited, as petitioner's share of attorney fees and court costs incurred in defending a suit in tort charging fraud and asking damages in the sum of Ten Million Dollars in connection with the purchase of certain German-owned sugar interests in Hawaii. We believe in conclusion that the facts bring this item clearly within the scope of ordinary and necessary business expenses."



And they cite the leading case on that in the U. S. Supreme [69] Court, the Kornhauser case.

The Court: What case?

Mr. Wild: The leading case.

The Court: Yes.

Mr. Wild: It is Kornhauser versus United States, 276 U. S. 145. I believe that I referred to that in our memorandum which I have filed for Your Honor. So that is this case. And it is the Board of Tax Appeals holding that, and they are specialists in tax law, as we both know. They hold that a suit claiming damages for fraud—and our complaint shows that this was a suit claiming damages for fraud—raised issues which when successfully won caused the expenditures of legal expense and other expense in the court to become ordinary necessary business expenses in the conduct of the business.

The Court: Pardon me for interrupting—

Mr. Wild: Go on. I want you to, Your Honor.

The Court: Assuming that the Hackfeld litigants had prevailed, that is, the plaintiff in that case, who would have had to pay the Ten Million Dollars?

Mr. Wild: American Factors would have had to pay the Ten Million Dollars, but because American Factors would have been made liable by the fraudulent act of its agent. Whether or not American Factors could get that Ten Million Dollars back again is a different question. There is no question if the court held that there was fraud, and as the

prayer was that all the assets of Factors be held to answer to the claims, Factors would have been liable to pay the Ten Million. Of course, as between Factors and itself it has a cause of action against the others who fraudulently injured it to make up the payment, you see, Your Honor.

The Court: Well, they have been capable of paying it presumably.

Mr. Wild: Well, I don't know whether they were or not, Your Honor.

The Court: Upon their appraised assets of Seven and One-Half Million, what is that?

Mr. Wild: American Factors had assets of Seven and One-Half Million Dollars; that is, Seven and One-Half Million were paid for them. American Factors, Limited, had only paid that amount, but it did have all the assets of H. Hackfeld and Company, Limited, whatever they might be. And it had assumed all the liabilities. And if they lost the case, it meant the end of American Factors, Your Honor. The whole life of American Factors was at issue in that cause.

The Court: Well, would there have been no liabilities attached on the other defendants?

Mr. Wild: Yes, Your Honor. There are two things that might have occurred there. The first of those is this: if these men who had formulated American Factors had acted [71] fraudulently, the court would have been bound to have given judgment against American Factors for the amount of the fraud, because constructively American Factors

would have been liable for that fraud. Now, as to constructive fraud of its agents who participated in the formation—right at that juncture, if the court so held, then all of the assets of American Factors would have been liable for a judgment. But American Factors would have had a cause of action for whatever damage the fraudulent act of these others had occasioned them.

The Court: Well, wouldn't the property, the assets of every one of the defendants be liable to the extent of the whole?

Mr. Wild: Yes, Your Honor; yes, Your Honor. And so would American Factors.

The Court: Upon execution?

Mr. Wild: Yes, Your Honor.

The Court: So they are all equally liable for Ten Million dollars a piece?

Mr. Wild: No, not a piece.

The Court: I mean until the Ten Million Dollars was paid out of somebody's property.

Mr. Wild: That's right.

The Court: Well, presumably the American Factors would be the easiest one to get your satisfaction of judgment from. [72]

Mr. Wild: That's right.

The Court: That's only an idle presumption because Alexander and Baldwin and Castle and Cooke and the others that were involved, they had assets of equal value. The execution against them would have been just as good as against the American Factors.

Mr. Wild: Well, it might or it might not. I don't know, Your Honor. They didn't pray—they prayed that the execution be as against the interests of these people in American Factors, so far as it was against them.

The Court: In the prayer of the bill?

Mr. Wild: Yes. There isn't any question that this was a suit designed, if won, to break American Factors and get control of American Factors again. There isn't any question about that, because if the judgment of the court had been that the defendants other than Factors who had acted fraudulently, the Factors then would have been responsible for the fraudulent acts of the others in bringing American Factors into being, without any question. And being so responsible, you could collect a judgment or get a judgment against Factors. And in the prayer they asked for judgment against them all, for judgment against the individuals; and asked in that event that Factors be held to be a trustee for the individuals to hold their share in the corporate assets or to hold the stock, whatever interest they have. [73]

The Court: But that wouldn't have relieved the other defendants from their liability.

Mr. Wild: No, Your Honor.

The Court: I just wanted to get that straight.

Mr. Wild: Now, the test on the right of reimbursement there is very clear. The test on the right of reimbursement is whether or not any one of those twenty other defendants got any secret advantage

for themselves out of the transactions other than that which American Factors received. You see, originally there were some 760 or 55 original stockholders. I don't remember the exact number. Of that number, as Your Honor knows, 25,000 shares were allotted to this group of defendants charged in paragraph 20. And they were charged with having occasioned the sale to reap a benefit for themselves as against everyone else in the picture.

After nine months of litigation it was finally held that those 20 did not receive any, not one iota of benefit in addition to what American Factors received or the other shareholders received prorata. And as that was the final holding, which was finally sustained in the year '32, it is our contention there that that foundation, that very factor and the fact that it was a suit in fraud, founds the right of those who paid the expense of the litigation and didn't get any special benefit to demand from American Factors reimbursement for all expenses. [74]

Now, there is one other very interesting question there which is really immaterial now, and Your Honor suggested it this morning, that the litigation actually didn't terminate until the Supreme Court of the United States refused certiorari. But it refused certiorari just after the annual meeting, and as it did, all those factors came into being which made the decision and judgment final in the year 1932. If there had been a reversal, the Government would have had a case. But there was no reversal.

Now, Your Honor, if I might go on just one step



further. I have adverted this morning to the decisions of the U. S. Supreme Court, and I have cited them in this memorandum to Your Honor. The latest expression on ordinary and necessary business expense is that, I believe, of Commissioner of Internal Revenue versus Heininger. That is cited on page 3 of our memorandum. That is in 88 Law Edition, 171. I won't advert to the foundation behind that case but it was a very important case for this reason: Up until the decision in that case, Your Honor, if the issue had been a fraud claim as against the Government, the courts always denied the deduction as an ordinary and necessary business expense, and in this case they held that combatting fraud claims of the postal department, even though they lost, were ordinary and necessary business expenses deductible as such.

Now, there is another case which adverts to the situation, [75] and which might be of interest to Your Honor, which adverts to the situation where obligations of a prior bankrupt corporation were paid by a successor. That case is Welch versus Helvering, 78 Law Edition, 212. In that case the petitioner had been secretary of a prior corporation which went bankrupt. In order to reestablish his relations with customers whom he had known when acting for the Welch Company, he decided to pay the debts of the Welch Company so far as he was able. He did so and his business prospered. The court cited the statutes in force, and Mr. Justice Cardozo I think has ably stated the rule in that case

as well as it has ever been stated. And he states the rule applicable as follows:

“We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner’s business, at least in the sense that they were appropriate and helpful. He certainly thought they were, and we should be slow to override his judgment. But the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges upon capital. There is need to determine whether they are both necessary and ordinary. Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be [76] habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.”

Then citing *Kornhauser* against the United States, that leading case I referred Your Honor to.

“The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times

there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type."

It covers our case like a glove, except for one thing. In that case everybody admits there was no legal liability of any kind or so upon the taxpayer to pay the debts of a bankrupt firm for which he had been a secretary. He made those payments because he considered they were proper payments to be made. But there was no kind of an obligation, moral, legal or otherwise on him. The court said in that sort of situation, if those payments were not ordinary and necessary expenses of [77] business, they should be treated as capital expenses, and as additional compensation paid for his business.

Now, in our case, may it please the Court, applying this same rule, it is our contention that not only was there a legal obligation, there was an equitable and a moral obligation that arose upon the corporation in '32 to reimburse the expense of the litigation.

Now, I won't again advert to those authorities, Your Honor. I cited some this morning when we were discussing the other case. They are found in my brief. Now I would like to refer for a moment—I might say in passing this, Your Honor, that the Matson Navigation Company case allowed the expense as an ordinary and necessary business expense, in 1932, when the Matson Company was reimbursed the amount of reimbursement as taxable

income to them. The revenues don't suffer. So that Your Honor is not asked to pass upon the question of whether or not the revenues suffer at all. They don't. If these other taxpayers got a deduction and it was allowed, they got a deduction from their return when reimbursement was made, and the reimbursement is taxable income to them. So that the revenues of the United States don't suffer. And there is no equity in the Government's case on that ground.

Mr. Atherton: May I interrupt here a moment?

Mr. Wild: Yes. [78]

Mr. Atherton: I am just wondering if counsel isn't going beyond what I understand to be an opening statement. He is purporting to argue his case when all the evidence is not in yet. I rather think that his statement ought to be limited to what he expects to prove and boil the thing down to those issues. I believe his argument shows that his case is put in.

Mr. Wild: Well, may it please the Court, I just assumed that His Honor wanted the statement of our position and what it was.

The Court: Well, so I do. But it does put opposing counsel at some disadvantage in a matter of argument to present argument as you go along in support of your contentions as to what your case is.

Mr. Wild: I will confine it, Your Honor.

The Court: I think perhaps it would be better to do that in view of the objection.

Mr. Wild: Yes, I'd be very glad to. I had un-

derstood both from counsel and Your Honor that you wanted a pretty full statement of our position.

The Court: Well, I do. And I recall saying that to you when you said that you would open with a rather lengthy opening statement. I expressed my agreeableness to having you do that. But as to argument in support of your position all the way through I think perhaps that you had better defer [79] that.

Mr. Wild: Omit that?

The Court: Yes.

Mr. Wild: Very well. Perhaps I should withdraw my memorandum from counsel because I had anticipated that was what Your Honor wanted.

Mr. Atherton: Do I understand that is to be his trial memorandum, Your Honor? I have read it and it looks to me as if it is rather a complete memorandum. I don't see how it could be amplified very much without writing a book.

Mr. Wild: Well, it has something I knocked off yesterday——

The Court: Which you just put on my desk.

Mr. Wild: And it was just completed today.

The Court: Well, I will read that overnight. Point out the salient things in connection with your contentions or case.

Mr. Wild: It is, then, Your Honor, our contention, after the contention that this is an ordinary and necessary business expense, or it is part of invested capital, that it must be one or the other, that it was all allowable to American Factors in the calendar year 1932 because American Factors was



on the accrual basis. Now, Your Honor, the total expense of the Hackfeld litigation was \$568,607.76. Of that amount we will show that the sum of \$87,992.50 was paid in the year [80] 1932, and that practically none of that expense was known or settled so that the amount of it was in doubt at the beginning of the year 1932. In other words, those were the final expenses, some of which weren't settled until in July when the last item, the biggest item in there, practically the whole amount, was paid as final counsel fees. We will show that, Your Honor.

We will show that under no circumstances could that have accrued in any prior year.

We will also show that of the expenses the sum total of \$396,812.50 of those expenses, that those were expenses already in evidence in part which were paid by the defendants other than American Factors under the agreement; that during a part of the time American Factors had billed and received more in cash from the defendants than the actual expenses which had been paid because they knew there were other items coming; that the balance——

The Court: American Factors had collected from this "hui" \$396——

Mr. Wild: \$396,812.50.

The Court: They collected all that and paid it out?

Mr. Wild: That's right, they collected all that and paid it out. That American Factors, Limited, was in the original meetings made, as it were, the

banker of the group; that is, the American Factors, Limited, were to receive the [81] bills to pay, to pay the bills, but charge all bills to this group; that they carried these items in a deferred account in the books called "Hackfeld Litigation." And that originally there was no agreement at all that this treatment of them would be final. Otherwise the books would not have shown "Hackfeld Litigation." That after the decision in the court by the trial court, the amounts that were paid out were trifling, only some \$80,000, and that there was no billing made on those awaiting the final determination of the case to see what happened. That is, they didn't bill those to the other defendants.

The Court: Although they had paid them?

Mr. Wild: They paid them but they hadn't billed them out of it. Those were waiting in suspense during that period of time.

The Court: There wasn't at any time, or was there—I am asking the question—was there at any time any agreement between this group of stockholders and organizers and American Factors as an entity as to how much these shareholders had agreed to contribute prorata in accordance with the number of shares they owned?

Mr. Wild: Yes, but they agreed to pay all the expenses, not contribute prorata, but to pay all the expenses of the Hackfeld litigation prorata to the shares.

The Court: So that there wasn't any occasion

for any [82] agreement as to what the firm, the corporation, American Factors would pay?

Mr. Wild: No.

The Court: They were to be left free of any expense?

Mr. Wild: Until the final litigation was turned out. Then the question as to whether or not they were to pay the expenses or any part of it was left open. There is no written agreement.

The Court: That is all covered in this—wasn't there some written agreement, wasn't something put in the evidence to show there was a written agreement between these contributors?

Mr. Wild: Yes, there was. That written agreement was this, Your Honor, that if joined as defendants in any suit or suits, they would pay together all of the expenses of the litigation, all of the expenses of the litigation which were approved by the so-called steering committee, or four out of five of them, and the steering committee was A. W. T. Bottomley, Frank Atherton, Richard Cooke and C. R. Hemenway, and they were to pay those expenses prorata to the number of shares that they had originally subscribed, so that if a stockholder owning a half, 25,000 shares, had signed that agreement, and if they had all been sued, then they would have paid all the expenses of the litigation prorata to the number of shares which they subscribed or to the 25,000, as all were sued. [83] So that there wasn't any part of the litigation expense to be shared by American Factors as they went along.

The Court: I see now.

Mr. Wild: These men were charged with fraud, Your Honor, and being charged with fraud motivated them to enter into this agreement to pay all litigation expenses and await final determination to see whether they were busted or whether they were held to be free from fraud, which I take it and I apprehend is a correct view, Your Honor. I think that is the honest and honorable view to take.

Now, then, the request was made, as somebody had to pay the bills, that American Factors as bankers for the group advanced all the money necessary and billed them for it, and then await a final outcome of the litigation to ascertain who was to be reimbursed, you see, or anyone—if they lost the case we admit there would have been no reimbursement.

Now, the next of our contentions there, Your Honor—may I pause just a second? Then, Your Honor, our position under the law concerning reimbursement, I cited this morning in answer to a position taken by Government counsel; and our position there is pretty fully stated on pages 6 through 12 of the memorandum which I presented to Your Honor. Briefly our legal position on that is simply this: as there was a conferring of benefits, and that benefits were conferred alike upon all stockholders of the corporation, or the [84] corporation, that there was raised an obligation under the law pertaining to restitution for American Factors to pay the same.

Our second point on that is this, that even if there was no obligation under the law to pay a nickel of it, there was an obligation in equity, and if there was no obligation in equity then the amount advanced would be a capital item, deferred payment for the assets and businesses of H. Hackfeld and Company, Limited. And we have cited authorities on all those points.

Now, if Your Honor will excuse me a second,—I think I have amply made the skeleton of our position clear to Your Honor—if Your Honor will excuse me a second.

The Court: Yes. Well, it is probably beside anything that is involved here but nevertheless it creates in my mind a passing wonderment: these contributions were made by the several people as set out here on page 15 of the stipulation in different amounts and different years, beginning with 1924 and 1925 and 1926, and I was wondering if these parties, all of whom are no doubt taxpayers, if they had at that time a sufficient confidence or belief in restitution of the amounts. Didn't they return these as expenses, outgoes, in their release with the tax department? Take, for instance, C. Brewer and Company in 1924; they contributed \$10,350; Alexander and Baldwin and Castle and Cooke; and then the following year [85] 1925, \$8,050; and the following year, '25 to '26, \$21,850 a piece. Did they get credit in their tax returns for those outgoes?

Mr. Wild: I don't know, Your Honor. I can



say this, I discussed this case with counsel in Washington. I was told by that counsel that a good many of the contributors had deducted litigation expense and it was allowed on the basis of the Matson case. We also agreed that if I was right in my discussion of the other case, and in any event, when they paid in the money they were under obligation to return it as taxable income in the year in which they got the reimbursement. I mean there isn't any issue about that, and it really has no bearing on our case as far as I can see. Even if these fellows had cheated the Government, I don't think it would have any bearing in our case.

The Court: They probably will come out short-handed if they took deductions over a string of years in smaller amounts and then received the total of their outgo all in one year; they probably paid more tax than they saved by the deductions.

Mr. Wild: They might, Your Honor. It might well be, except for this factor, that during some of those years, Your Honor, rates were going up a little.

The Court: They are going up all the time.

Mr. Wild: They may have paid a little more tax on the income. And actually, after the Government reimburses us it [86] may find that the Government is ahead on that very point that Your Honor has stated, because they collected more tax than these fellows from the reimbursement, than these fellows got as deductions as they went along. But actually that is beside the point on our case,

as I see it. It wouldn't make any difference as to the merits of our case whether these fellows had paid any taxes or not, as I see it. My only point in citing the Matson case was that a technical tax court body that deals with tax court cases had judged where this was a case where it was ordinary and necessary.

The Court: The difference, though, as I see it at a glance, the difference between the Matson Company and the American Factors is that no one had assumed that burden for the Matson Company and it was a necessity to them no doubt.

Mr. Wild: At that time, yes, Your Honor.

The Court: To protect themselves. But in the case of the Factors, it appears to me that it wasn't a necessity on their part because someone else had offered, and there was a protection of their own interests and reputation, and so forth, to carry the burden.

Mr. Wild: Yes, Your Honor. The statement of facts is accurate in part; the understanding, however, was that the issue was to be open. And on the question of law, Your Honor, it is our contention that on the facts as you stated them, and on the authorities as we have cited them, even if there [87] had been no agreement of any kind or sort, the law raised an obligation upon American Factors to pay. And as it was an obligation on their part in that year to pay, that their payment was the ordinary, necessary expense that is contemplated. And even if we are wrong on that, then, Your Honor, under

the Welch case it is our contention that it is an additional capital outlet for the purchasers of the assets and businesses of H. Hackfeld and Company, Limited, which is an additional capital of American Factors.

Now, we rest secure, Your Honor, on the rule of law concerning restitution. I don't want to argue that point now. I merely state my position. The position there is this, Your Honor: Take the case of the ordinary stockholders' suit against officers of a corporation. The officers of the corporation in the first instance pay all the expense of litigation. In that suit where it is directly stockholders, derivative suit or direct stockholders' suit against the officers, the stockholders pray that any benefit is to go into the corporation. Now, when that suit is successfully defended and it is finally held that there was no negligence or other unlawful act of the directors, the law there is that immediately an obligation is raised for the corporation to pay all the expenses of that litigation. And in my memorandum I have cited the authorities on that, too, Your Honor. So that our position is very clear. It is this, that upon [88] conclusion of the litigation, as it was definitely determined that these defendants were not fraudulent, as it was definitely determined they got no benefit other than the benefits which accrued to the corporation as a whole, then under the doctrine of the law of restitution, supported by cases cited, then and for the first time there arose an obligation on the part of American Factors.

Now, American Factors didn't have to submit to suit by these people to determine the question as to whether they had a legal liability. They could make a statement to the stockholders that there were these liabilities. There was a legal liability; there was a moral liability. We will go into that opinion rendered. The minute that the stockholders passed that, it was unnecessary to file litigation.

But it is our contention there that the minute that the stockholders accepted that obligation by the corporation to reimburse these people and pay all the expenses on the basis that they did, there certainly was a clear legal liability in favor of any of these stockholders to get reimbursement. And we didn't have to litigate it in court.

Now, it is also our contention, your Honor, that even if the stockholders had voted No, we wouldn't reimburse a nickel of it, it is our contention, your Honor, that they are then and there obligated, that they there and then accrued the obligation to reimburse under the authorities stated, and [89] to reimburse in full; and that once the court had so determined, there is no question that there would be a deduction.

The Court: It seems to me, my present view of it is, that if there was, as you contend, a legal obligation, liability resting upon factors to pay that expense, that it would amount to this, that they simply had to pay that much more than they had in the beginning expected to pay to gain the ownership free of all claims and encumbrances, that much

more than they had theretofore paid. So that it would be just simply an addition to their capital outlay.

Mr. Wild: Your Honor, that is entirely a possible holding. It would be supported by the Welch case, your Honor. If your Honor finds that this isn't an ordinary and necessary expense of litigation, then in any event it is clearly an additional amount paid for the business, good will and assets of H. Hackfeld and Company. And it is a deferred amount, your Honor.

The Court: I don't want you to gather that I have any firm mind on that. I am raising these for the purpose of getting a better understanding, and not to express any——

Mr. Wild: Yes, I understand that, your Honor. It is either one or the other. It is either an ordinary and necessary business expense allowable in toto in the year '32, or it is an additional amount paid by American Factors as deferred payments for the business and assets of H. Hackfeld [90] and Company, Limited, and a new capital amount to be set up in their books as a capital account, additional cost of Hackfeld assets. Now, your Honor, it is either one or the other. And this case, as I see it, calls upon your Honor to decide which. It is our feeling and our contention that the first view, that is, that it is an ordinary and necessary business expense, is the sound view. That is all, your Honor. But your Honor's question is a very intelligent one there, and your Honor has put your finger, as I see



it, right on the crux of this whole matter, of the matter as I see it. The crux of the matter isn't whether or not we should have paid it. The crux of the matter is, acknowledging that we acknowledged the obligation, should it be capital, additional payment, or should it be ordinary and necessary business expense deductible in the year '32?

Now, your Honor, I must say that I have made a somewhat scattery opening statement, and I'd like now to put on Mr. Lowrey, unless Government counsel wants to make a statement at this time.

Mr. Atherton: Well, all the Government contests at this stage of the proceeding is that its position is that no part of these litigation expenses were ordinary and necessary expenses of the taxpayer, and therefore not properly deductible, and that it does not follow as a necessary corollary from the premise that they are not properly deductible as expenses, that they should be treated as additions or deferred payment on account of the purchase of the assets.

Mr. Wild: Well, what is your alternative, then? If it isn't ordinary and necessary business expense, what is it?

Mr. Atherton: I don't think it is necessary for the Government to state what the alternative is now. We will develop that after the evidence is in.

Mr. Wild: I mean, what your position is.

Mr. Atherton: My position is that it can be a capital item without constituting—a capital expenditure without constituting a cost of acquiring the assets.

Mr. Wild: You mean——

Mr. Atherton: That is perfectly clear. I think you clearly understand the Government's position, don't you, your Honor? That an item can be a capital expenditure and not allowable as deduction as an ordinary and necessary business expense and be capitalized, be treated as a capital expense like, for instance, an organization expense without necessarily constituting a deferred payment on account of the acquisition of the assets; organization expenses, like attorneys fees, and organizing a corporation, and those types of expenditures are not part of the cost of acquiring a business. They are not items to invest in capital whatsoever.

Mr. Wild: Well, I might state in that position, your Honor, that it is clear that attorney fees and other organization [92] expenses are part of the capital of an organization or you can't depreciate them. You consider them as a part of your invested capital, and it is our contention that counsel for the Government picked a pretty poor lemon when he raised his position, because his authorities that he purports to cite don't bear him out. They bear out my contention. Well, anyhow, we will argue that later.

The Court: Well, then, you may proceed with the evidence.

Mr. Wild: How late does your Honor desire to sit tonight?

The Court: Let's have a recess to relieve the reporter.

(A recess was taken at 3:05 p.m.)

After Recess

Mr. Wild: Mr. Lowrey, will you please take the stand.

SHERWOOD M. LOWREY

a witness in behalf of the Plaintiff, being duly sworn, testified as follows:

Direct Examination

By Mr. Wild:

Q. Will you please state your name?

A. Sherwood M. Lowrey, L-o-w-r-e-y.

Q. And where are you a resident?

A. Hilo, Hawaii.

Q. And how long have you been a resident in Hilo?

A. About four months.

Q. And before that where were you a resident?

A. Honolulu.

Q. And for how long?

A. About 60 years.

Mr. Wild: Your Honor, at this time, if counsel has no objection, I'd like to put Mr. Lowrey on simply the Hackfeld issue. I don't want to go into the pension issue or the Henry Waterhouse Trust Company issue until a later time. And if it is agreeable to counsel, it is understood I may recall him?

Mr. Atherton: Yes.

Q. (By Mr. Wild): Were you an officer of American Factors, Limited, Mr. Lokrey?

A. Yes, I was treasurer of the company from

(Testimony of Sherwood M. Lowrey.)

the early part, middle of 1920 until I retired in April of this year.

Q. And during all that time you acted as an officer of the company? A. Yes.

Q. And what was that officer?

A. Treasurer.

Q. Treasurer of the company? In your position as treasurer of the company, did you have anything to do with the Hackfeld litigation?

A. I did.

Q. And will you state your first connection with the [94] Hackfeld claims?

A. When the rumors reached us to the effect that certain of the former shareholders of Hackfeld and Company were going to bring a suit against possibly the company or against a possible group of individuals, it was all very vague when it first reached us. A number of the directors were called together and it was finally decided at that time that it would be necessary for the company to take and secure counsel in order that counsel become acquainted with the facts of the case and be in a proper position to advise the company or the individuals who might be sued.

Q. Was there any discussion with any individuals?

A. That was the first step. Secondly, as these rumors crystalized it then became known, as I remember it, as to who the individuals were that were going to be sued, the individuals and the cor-

(Testimony of Sherwood M. Lowrey.)

porations. And it finally came down to a group, the names of which have been submitted already in this case, as having been the ones who formed the nucleus and made a request for the 27,000 shares or a majority of the stock at the time the company was formed, and who later on were allotted 25,000 shares.

Q. I am calling your attention to the original of an agreement dated July the 29th, 1924—which is the same, for the purposes of the record, your Honor, as Exhibit 1 annexed to Exhibit P-5—and ask you whether you have ever [95] seen the original of that? (Showing a document to the witness.)

A. I have.

Q. And what, if anything, did you do with that original?

A. When it was finally decided or known against whom this suit was to be brought, the signators through this group met and decided it was necessary for them to have counsel. It was indicated that the suit was going to be against them for fraud and conspiracy. It was necessary for them to take and defend themselves. Therefore, it was decided among them that they would take and form this group, “hui” as we use the term here, would take and bear the expenses of defending the suit which was against them in a large part, and to prorate the expenses among themselves in accordance with the number of shares of stock that they had originally either applied for or been allotted, been allotted I think.



(Testimony of Sherwood M. Lowrey.)

Q. Now, did they make any request of American Factors in connection with that agreement?

A. Well, this agreement—there was some 22, as I remember in this agreement. It was necessary for them, in accordance with this agreement, to have a steering committee. The steering committee was, as has been indicated here or stated here, was Mr. Bottomley, Atherton, Hemenway and Cooke. And the gist of the agreement is that this group would underwrite [96] write and pay all the expenses in connection with the defense of this suit as might be determined as properly due by that committee of four that I have just named.

Q. And was American Factors to perform any function in connection—

A. Yes, it then came down to the point, as the litigation developed, it would be necessary for somebody to take and put up the immediate cash to take and pay the bills as the bills were presented rather than going around and trying to collect from the group a certain small amount each time a bill had to be paid. Hence, American Factors acted as a banker for that committee, and as such banker we took and paid the bills as approved by that committee. The committee took and approved all the large bills, and as treasurer of the company I was told to take and settle all minor, ordinary bills, cable expenses and miscellaneous expenses in connection with the suit, which was done. And then, after a considerable amount had

(Testimony of Sherwood M. Lowrey.)

been paid out, we estimated with the number of shares it might take an assessment of two dollars, it might take an assessment of two dollars and a half or it might take an assessment of more than that to collect from this group of 22 an amount that would practically offset the amounts which had already been paid out in order, so to speak, balance this account.

This account was kept merely as a means of convenience [97] for the whole group so a record would be held in one central place as to where the money had gone to, for what purposes it had been used, and, on the other hand, to keep track of the amounts that had come in from the various members of the group, to show the status of the thing at any time that they wanted to try and strike a balance on it.

Q. Now, you mentioned a steering committee. There isn't any such name annexed to anybody in the agreement. Whom do you mean by the steering committee?

A. I mean the four that were named in this to take and handle the matter on behalf of the whole group. In other words, there were 22, as I remember it in there, and it was necessary to have somebody head it all up because some of these individuals were located in San Francisco, some of the corporations were California corporations, and it became necessary to have somebody head the thing

(Testimony of Sherwood M. Lowrey.)

up so that the defense is prepared and set forth to be done in an orderly manner.

Q. Now, at this time I will show you another duplicate of the instrument dated July 28, 1924, and ask you if you have ever seen that before? (Showing a document to the witness.)

Mr. Wild: Through error, I might state, your Honor—I had shown these instruments to counsel—we found that there was another duplicate signed, and I just want to get that one in the record. [98]

A. Yes, Mr. Andrew Welch.

Q. And how many shares opposite his name?

A. One hundred.

Q. Did American Factors sign any copy of this agreement? A. No.

Q. Never? A. They did not.

Q. Now, are any of the men in that so-called steering committee now alive? A. No.

Q. Is it the sense of your testimony that this steering committee directed the litigation, approved the bills kept, routine bills, is that what you have just testified to? A. That is true.

Q. And did you meet with that steering committee at various times?

A. From time to time with members of the committee.

Q. And at the time that this agreement was entered into, was there any agreement between the members, or put it this way—I will withdraw that question. Was there any agreement between Amer-

(Testimony of Sherwood M. Lowrey.)

ican Factors, Limited, and the other defendants who signed this agreement, Exhibit 1 annexed to P-5, as to who was ultimately going to bear the cost of litigation? [99]

A. When it started out the thing was in such a nebulous state, the whole thing, that these men and corporations had to get together to protect and defend themselves. For a long period of time it wasn't known how the outcome of that suit was going to finally end up. In fact, we didn't know it until the appeal to the Supreme Court of the United States—or that legal term that you used there—was denied there. We didn't know who was going to finally have to pay those bills, for the simple reason that if these men had been convicted of fraud——

Mr. Atherton: Excuse me, your Honor, I think his answer now to this extent is not responsive to the question. I move that it be stricken.

The Court: Well, I think the objection is well-grounded. It is not responsive to the question.

Mr. Wild: As I understand the rules of evidence, your Honor, I am the only one that could make the objection, if it is not responsive to the question. So if counsel wants to make a good objection, it is all right with me. That is Jones on Evidence, and I have forgotten the page.

The Court: I think that is perhaps technically right. But the motion to strike could be grounded upon so many other cases.

(Testimony of Sherwood M. Lowrey.)

Mr. Wild: Yes, your Honor.

The Court: I think that the latter part of the statement [100] may be stricken. You have answered the original question?

The Witness: Yes.

Q. How were the payments, as they were made, entered in the books of American Factors?

A. There was one account entitled "Hackfeld Litigation." That account was charged with the monies that were paid out, and that account was credited with the monies that were received.

Q. I think I furnished counsel for the Government with a copy of that itemization. Do you have with you an itemization of that account as it appears in the books of American Factors?

A. I have.

Q. And that was a copy made from the books?

A. It is a copy made from the books, and there is a covering letter bearing my initials in which this or a copy of it was sent to the Internal Revenue Department in 1936.

The Court: May I see that? (Witness hands document to the Court.)

Mr. Wild: I might say that I am putting this in at the request of the United States. The United States said they might object to some items of expenses as not being allowable anyhow.

The Court: Yes. [101]

Mr. Wild: This is an itemized list, and this list was prepared at the request of the United States



(Testimony of Sherwood M. Lowrey.)

and was furnished to the United States, as you testified?

The Witness: According to that covering letter, yes.

Mr. Wild: I would ask that this be received in evidence. And is that P-7?

The Clerk: Yes, P-7.

The Court: Any objection?

Mr. Atherton: No, your Honor, no objection.

The Court: This is an itemized list of accounts of litigation expenses?

The Witness: That is the outgo, Judge, if I may say. That sheet does not show the income.

The Court: Yes.

The Witness: That is the charges against them.

The Court: Yes.

(The document referred to was received in evidence as Plaintiff's Exhibit P-7.)

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## PLAINTIFF'S EXHIBIT P-7

Admitted

May 12, 1936

Office of the Internal Revenue Agent in Charge,  
Honolulu, Hawaii.

Gentlemen:

Attention: Mr. Peterson

In accordance with your verbal request, we are handing you herewith two copies of an itemized

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-7—(Continued)

list of the Hackfeld Litigation Expenses for the period June 25, 1924, to December 31, 1932.

Yours very truly,

AMERICAN FACTORS,  
LIMITED,  
S. M. LOWREY,  
Treasurer.

SML:EW

Itemized List  
Hackfeld Litigation Expense  
June 1924 to Dec. 31, 1932

1924

June 25	Auto Hire—Mr. Wirtz.....	\$ 4.00
27	Travel Expense—Mr. & Mrs. Hemenway to San Francisco .....	400.00
	Travel Expense .....	7.50
30	Retainer Fee—Lucian H. Boggs.....	1,000.00
	Travel Expense—G. Montgomery to Washington .....	49.25
July 14	Telephone—N.Y. to Washington.....	12.50
	Cables for June—Honolulu.....	529.90
	Wireless for June—Honolulu.....	83.18
15	Retainer Fee—Pillsbury, Madison & Sutro	7,500.00
18	Fee—C. R. Hemenway.....	2,500.00
18	Travel Expense—C. R. Hemenway.....	575.15
22	Retainer Fee—Henry Holmes.....	2,500.00
23	Travel Expense—C. R. Hemenway & wife San Francisco to Honolulu.....	400.00
23	Freight & Express—Documents S.F. to Washington .....	5.97
23	Fee—C. R. Hemenway.....	1,000.00
23	Cables for June—New York.....	106.47
31	Photograph of Tax Report.....	10.56
31	Cables for June—S.F. ....	264.65
31	Fee—Lucian H. Boggs.....	1,000.00
Aug. 15	Wireless—Honolulu .....	118.20
15	Wireless—Honolulu .....	6.10
20	Telegrams—S.F. ....	41.03
20	Travel Expenses Telephone, etc. refunded to Mr. Boggs .....	1,170.17

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-7—(Continued)

	30	Cables—S.F. ....	73.90
	30	Newspapers to Mr. Sutro.....	2.50
Sept.	11	Auto Hire—Mr. Wirtz.....	1.50
	15	Auto Hire—Mr. Wirtz.....	5.00
		Incidentals—S. M. Lowrey.....	4.80
	16	Cables—S.F. ....	11.75
	22	Cables—Honolulu .....	185.92
	22	Cables—Honolulu .....	4.90
	22	Cash advanced to Lucian H. Boggs.....	1,500.00
	26	Fees, Smith, Warren, Stanley & Vitousek...	3,000.00
	30	Cables—S.F. ....	197.98
	30	Telegrams, Telephone & stenographer— Pillsbury, Madison & Sutro.....	278.14
Oct.	7	Sundries—S. M. Lowrey & A. J. Wirtz.....	1.80
	9	Sundries—S. M. Lowrey & A. J. Wirtz.....	1.50
	11	Newspapers to Mr. Sutro.....	2.00
	15	Sundries—Refund to Mr. Drew, S.F.....	34.55
	21	Cables for Sept.—Honolulu .....	358.25
	21	Cables for Sept.—Honolulu .....	13.80
	25	Telephone—Mr. Anderson to Mr. Palmer, S.F. to Boston .....	114.50
			<hr/>
			Forward.....\$ 25,077.42

[101b]

1924		Forward.....	\$ 25,077.42
Oct.	25	Travel Expense \$406.25 and Telephone & Cables—Pillsbury, Madison & Sutro.....	651.51
		Fees—Pillsbury, Madison & Sutro.....	2,000.00
	31	Cables for Sept.—S.F.....	388.03
Nov.	12	Wireless to G. N. Wileox from Honolulu....	13.20
	12	Wireless to Sutro and A. W. T. Bottomley..	7.92
	12	Travel Expense—Sutro & Atherton to Honolulu .....	350.00
	18	Travel Expense—O. Sutro.....	350.00
	20	Travel Expense—Sutro to steamer.....	1.50
	24	Travel Expense—A. W. T. Bottomley in S.F. ....	280.00
	25	Travel Expense—R. H. Trent in S.F.....	125.00
	25	Travel Expense—A. J. Wirtz to S.F.....	135.00
	25	Wireless—Honolulu to Sutro .....	5.58
	25	Sundries—Suit case for documents .....	9.23
	26	Travel Expense—Mrs. Hemenway to S.F...	375.00

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-7—(Continued)

	26	Sundries—Expenses and Insurance on Documents .....	52.95
	26	Telegrams, telephone & copy work—repaid to Pillsbury, Madison & Sutro.....	521.70
	26	Expense Bill of C. J. Heiser.....	503.00
	29	Cables—Honolulu .....	463.31
	29	Sundries—Registration Cable address “Oscart” .....	2.50
	29	Fee—Eberhard Haynes .....	2,000.00
Dec.	5	Sundries—Newspapers .....	1.00
		Sundries—Newspapers to Mr. Sutro.....	2.80
	12	Cables—S.F. ....	455.44
	15	Cables—Honolulu .....	130.84
	16	Travel Expense—Mr. Hemenway.....	250.00
	16	Fees—Final Payment Lucian H. Boggs.....	8,000.00
	16	Fees—Oscar Sutro .....	50,000.00
	16	Travel Expense—Oscar Sutro on trip East..	750.00
	16	Travel Expense—Oscar Sutro—Honolulu & return .....	351.14
	16	Expenses—L. H. Boggs—balance of expenses .....	71.30
	17	Fees & Expenses—Smith, Warren, Stanley & Vitousek.....	7,113.25
	24	Sundries—Drayage on documents S.F.....	1.50
	24	Cables—C. R. Hemenway's cables to Honolulu .....	2.80
	24	Expenses—Pillsbury, Madison & Sutro.....	567.27
	27	Expenses—C. R. Hemenway.....	250.00
	27	Expenses—C. R. Hemenway .....	200.00
	27	Expenses—A. J. Wirtz.....	127.88
	27	Fees—A. J. Wirtz Cash advanced to W. H. Lawrence of Pillsbury, Madison & Sutro..	5,000.00
	31	Expenses—A. W. T. Bottomley.....	620.00
	31	Sundries—Press Clippings—Allens Press Clipping Bureau .....	3.00
	31	Travel Expenses—R. H. Trent.....	620.00
	31	Travel Expenses—C. R. Hemenway.....	200.00
Forward.....			\$108,031.07

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-7—(Continued)

1924	Forward.....	\$103,031.07
Dec. 31	Travel Expense—A. J. Wirtz.....	125.00
31	Cables & Wireless.....	96.50
31	Cables & Wireless—Honolulu.....	86.95
31	Sundries—postage, etc. ....	7.43
31	Expense—C. R. Hemenway.....	100.00
31	Radio—refund to Alexander & Baldwin.....	3.70
Total Expenses 1924.....		<u>\$108,450.65</u>
1925		
Jan. 1	Radio—Frear to Sutro.....	\$ 14.75
20	Travel Expense—F. C. Atherton to S.F.....	125.00
20	Travel Expense—C. R. Hemenway in S.F....	200.00
21	Sundries—Postage .....	5.58
	Travel Expense—A. J. Wirtz in S.F.....	125.00
	Cables—S.F. to Trent Trust Co.....	11.75
22	Wireless to Hilo.....	6.30
22	Wireless to Kailua .....	6.60
22	Wireless to Hilo.....	3.75
27	Travel Expense—C. R. Hemenway in S.F....	200.00
27	Travel Expense—A. J. Wirtz in S.F.....	125.00
27	Expenses—Pillsbury, Madison & Sutro.....	609.31
27	Sundries—Press Clippings—Allen's Clipping Bureau .....	5.88
31	Travel Expense—C. R. Hemenway in S.F....	200.00
31	Radio—Refund Alexander & Baldwin .....	10.00
31	Travel Expenses—C. R. Hemenway.....	100.00
Feb. 7	Fees—Atherton Richards .....	500.00
9	Wireless to Hilo.....	3.75
9	Wireless to Kailua.....	3.75
10	Travel Expense—A. W. T. Bottomley in S.F. ....	620.00
10	Travel Expense—A. J. Wirtz in S.F.....	125.00
13	Cables—S.F. ....	143.64
18	Travel Expense—W. F. Frear to S.F.....	135.00
19	Expenses—Pillsbury, Madison & Sutro— December & January disbursements.....	2,266.67
19	Radio to Frear.....	6.25
Forward.....		<u>\$ 5,552.98</u>



(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-7—(Continued)

1925	Forward.....	\$ 5,552.98
Feb. 19	Sundries—Press Clippings .....	16.16
19	Expenses—F. Eberhard Haynes for Dec.....	291.91
19	Travel Expenses—Richard H. Trent in S.F.	625.60
20	Cables for January—Honolulu.....	84.02
28	Travel Expense—A. W. T. Bottomley in S.F. ....	560.00
24	Travel Expense—R. H. Trent in S.F.....	340.00
24	Travel Expense—A. J. Wirtz in S.F.....	250.00
24	Sundries—postage .....	3.00
25	Sundries—Rental Monroe Calculating Machine .....	15.00
	Sundries—Stationery .....	10.05
26	Sundries—Express Charges .....	1.25
27	Travel Expense—R. H. Trent to Honolulu..	200.00
28	Cables for January—S.F. ....	158.68
28	Sundries—Binding 24 vols. of Star-Bulle- tin and Freight to S.F.....	46.00
Mar. 2	Travel Expense—Atherton Richards to S.F. ....	135.00
	Travel Expense—Geo. Sherman to S.F.....	350.00
5	Expenses—W. F. Frear.....	47.30
6	Travel Expense—W. F. Frear to Honolulu	175.00
	Expenses—F. C. Atherton.....	500.00
	Expenses—C. R. Hemenway.....	100.00
9	Travel Expense—A. J. Wirtz in S.F.....	125.00
10	Travel Expense—C. R. Hemenway in S.F..	742.22
12	Cables for February—Honolulu.....	28.25
12	Sundries—Newspapers to Sutro.....	5.60
13	Travel Expense—C. R. Hemenway in S.F..	330.37
13	Expenses—F. Eberhard Haynes for Jan....	632.89
13	Expenses—C. R. Hemenway.....	100.00
13	Travel Expense—F. C. Atherton to Honolulu .....	150.00
13	Travel Expense—F. C. Atherton.....	300.00
13	Travel Expense—F. C. Atherton—addi- tional charge on trip.....	25.00
31	Travel Expense—A. W. T. Bottomley in S.F. ....	620.00
21	Expense—C. R. Hemenway.....	200.00
21	Travel Expense—A. J. Wirtz in S.F.....	125.00
21	Sundries—Yosemite Taxicab Company.....	138.82
21	Sundries—Press Clippings .....	14.36
21	Expenses—Pillsbury, Madison & Sutro— Bill of March 6.....	2,204.36

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-7—(Continued)

23	Legal Fee—Holton, Richards & Co., Inc.....	5,000.00
23	Expenses—C. R. Hemenway.....	200.00
24	Cable .....	1.44
30	Travel Expense—Atherton Richards in S.F.	105.00
30	Cable—refund Alexander & Baldwin.....	25.00
31	Travel Expense—Mr. Stainback to S.F.....	125.00
Forward.....		\$ 20,660.26
1925	Forward.....	\$ 20,660.26
Mar. 31	Travel Expense—A. J. Wirtz in S.F.....	125.00
	Travel Expense—C. R. Hemenway in S.F....	100.00
Apr. 8	Cables—S.F. ....	37.62
	Sundries—Rent of calculating machine.....	15.00
	Travel Expense—Atherton Richards in S.F.	135.00
	Travel Expense—Atherton Richards to Honolulu .....	135.00
13	Fees—Atherton Richards .....	350.00
14	Sundries—Newspapers to Sutro.....	3.10
15	Expenses—C. R. Hemenway in S.F.....	200.00
	Expenses—C. R. Hemenway in S.F.....	100.00
	Expenses—C. R. Hemenway in S.F.....	358.53
	Sundries—Yosemite Taxicab Co.....	73.13
	Sundries—Press Cuttings .....	9.20
30	Travel Expense—A. W. T. Bottomley in S.F. ....	600.00
18	Expense—Pillsbury, Madison & Sutro— bill of April 3.....	1,905.46
18	Expense—C. R. Hemenway.....	250.00
18	Sundries—Rent of Calculating Machine.....	15.00
18	Expense—C. R. Hemenway.....	300.00
18	Travel Expense—A. J. Wirtz in S.F.....	125.00
18	Sundries—Postage .....	2.88
18	Sundries—Express .....	1.00
20	Cables for March—Honolulu.....	53.94
24	Travel Expense—Atherton Richards to S.F.	125.00
25	Cable .....	5.30
29	Fees—I. M. Stainback .....	1,000.00
29	Expenses—I. M. Stainback .....	245.00
May 4	Expenses—R. A. Cooke .....	1,250.00
8	Travel Expense—A. J. Wirtz in S.F. ....	125.00
	Expense—C. R. Hemenway.....	100.00
	Cables—S.F. ....	91.80

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-7—(Continued)

	Travel Expense—A. J. Wirtz in S.F.....	125.00
	Expense—I. M. Stainback.....	150.00
	Expense—C. R. Hemenway.....	100.00
	Cable to Judge Stanley.....	14.75
	Sundries—Taxi .....	1.00
11	Expenses—Pillsbury, Madison & Sutro.....	2,140.65
	Expenses—F. Eberhard Haynes for Feb. and March .....	1,585.69
	Travel Expense—A. J. Wirtz in S.F.....	125.00
14	Travel Expense—W. F. Dillingham— Steamer fares and expenses.....	1,000.00
18	Sundries—Yosemite Taxicab Co. ....	93.83
	Sundries—Press Clippings .....	9.88
	Sundries—3 copies of "Valuation of Industrial Securities .....	16.00
	Forward.....	\$ 33,859.02
1925	Forward.....	\$ 33,859.02
May 18	Travel Expense—C. R. Hemenway in S.F...	343.45
	Expense—C. R. Hemenway.....	200.00
	Travel Expense—Atherton Richards.....	105.00
	Cables—Honolulu .....	77.03
	Expense—C. R. Hemenway.....	250.00
22	Fees, etc.—W. F. Frear.....	3,031.80
27	Sundries—Garage Space in S.F.....	21.00
	Expense—Atherton Richards in S.F.....	105.00
	Expense—C. R. Hemenway.....	100.00
	Travel Expense—A. J. Wirtz.....	125.00
	Fees—Atherton Richards .....	1,500.00
	Fees—Holton, Richards & Co.....	3,500.00
	Sundries—Stationery .....	4.50
	Sundries—Comptometer & Operator 1½ days .....	15.00
	Cables for April—S.F.....	98.76
29	Expenses, etc.—Covington, Burling & Rub- lee Washington, D.C. ....	1,071.80
	Expenses—C. R. Hemenway.....	200.00
	Expenses—Atherton Richards .....	132.00
	Expenses—C. R. Hemenway.....	200.00
June 4	Sundries—Express Charges .....	2.00
10	Travel Expense—Advance to Old Colony Club a/c. W. H. Lawrence.....	373.12

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-7—(Continued)

10	Sundries—Rent of Typewriter.....	10.00
10	Sundries—Rent of Calculator.....	15.00
10	Expense—Pillsbury, Madison & Sutro— bill of May 24.....	2,290.95
10	Expense—Atherton Richards in S.F. ....	120.00
10	Travel Expense—A. J. Wirtz in S.F.....	125.00
10	Sundries—Stationery .....	4.70
12	Radios .....	31.55
15	Cables for May—Honolulu .....	99.63
16	Sundries—Newspapers to Sutro.....	2.95
15	Sundries—Garage Space S.F.....	15.00
	Travel Expense—C. R. Hemenway in S.F....	304.18
	Expense—C. R. Hemenway.....	250.00
	Sundries—Press Clippings .....	10.40
24	Expense—C. R. Hemenway.....	100.00
	Expense—Atherton Richards.....	111.00
	Travel Expense—A. J. Wirtz.....	125.00
	Expense—F. Eberhard Haynes Bill of May 30 .....	795.05
	Expense—C. R. Hemenway.....	250.00
	Sundries—Yosemite Taxicab Service .....	51.08
	Sundries—Underwood Typewriter Co.....	3.50
	Expenses—Atherton Richards .....	147.50
Forward.....		\$ 50,176.97

1925	Forward.....	\$ 50,176.97
June 24	Expense—C. R. Hemenway.....	50.00
27	Expense—C. R. Hemenway.....	200.00
27	Travel Expense—Atherton Richards in S.F. ....	105.00
27	Travel Expense—A. J. Wirtz in S.F.....	125.00
27	Fees—F. Eberhard Haynes.....	7,000.00
27	Travel Expense—W. H. Lawrence to Washington and back.....	321.90
30	Fees, etc.—Smith, Warren, Stanley & Vitousek .....	5,079.99
	Travel Expense—A. W. T. Bottomley to Honolulu .....	200.00
July 7	Sundries—Underwood Typewriter Co.....	10.00
	Sundries—Office Supply Co.....	20.00
	Expense—C. R. Hemenway.....	200.00
	Expense—Pillsbury, Madison & Sutro— Bill of June 29.....	2,066.17

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-7—(Continued)

	Expense—C. R. Hemenway.....	100.00
	Expense—C. R. Hemenway.....	50.00
	Expense—Atherton Richards .....	111.00
	Travel Expense—A. J. Wirtz in S.F.....	125.00
	Fees—Atherton Richards .....	2,000.00
	Fees—Atherton Richards .....	4,000.00
13	Cables for May—S.F.....	79.30
17	Sundries—Garage Space S.F.....	15.00
	Sundries—Press Clippings .....	6.80
	Expense—C. R. Hemenway.....	200.00
	Sundries—Yosemite Taxicab Co.....	73.80
	Expense—C. R. Hemenway.....	50.82
	Expense—C. R. Hemenway.....	200.00
	Travel Expense—A. J. Wirtz.....	125.00
	Expense—Atherton Richards .....	120.00
20	Cables for June—Honolulu.....	98.83
22	Expense—Atherton Richards .....	105.00
	Travel Expense—A. J. Wirtz.....	125.00
	Sundries—Underwood Typewriter Co.....	10.00
	Sundries—1 copy Valuation of Industrial Securities .....	5.00
27	Expense—Atherton Richards .....	150.00
	Travel Expense—A. J. Wirtz.....	125.00
	Expense—Lunch for five.....	7.20
	Radio .....	1.50
	Travel Expense—C. R. Hemenway to Honolulu .....	400.00
Aug. 4	Sundries—Newspapers to Sutro.....	3.10
	Sundries—Sign painting of Exhibits— George W. Watson.....	46.14
	Sundries—Stationery .....	1.95
	Travel Expense—A. J. Wirtz.....	125.00
	Expense—Atherton Richards .....	138.00
Forward.....		\$ 74,153.47
1925	Forward.....	\$ 74,153.47
Aug. 7	Expense—C. R. Hemenway .....	\$ 70.00
	Expense—F. Eberhard Haynes—bills of July 21 and 22.....	2,196.93
11	Cables for June—S.F.....	16.10
14	Sundries—Press Clippings .....	10.36
	Sundries—Office Supply Co., Ltd. Honolulu .....	10.00



(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-7—(Continued)

Aug.	Travel Expense—A. J. Wirtz to Honolulu..	115.00
	Sundries—Yosemite Taxicab Co.....	89.78
	Fees—W. H. Lawrence .....	5,000.00
	Fees—Atherton Richards .....	2,500.00
	Fees—C. R. Hemenway.....	10,000.00
17	Fees—Special audit of Insurance Dept. Records .....	400.00
22	Cables for July—Honolulu.....	19.08
26	Cables for July—S.F.....	50.29
31	Expense—Atherton Richards .....	210.00
31	Expense—Stenographic Service .....	30.00
31	Travel Expense—A. J. Wirtz.....	212.50
31	Expense—Pillsbury, Madison & Sutro— bill of Aug. 6.....	4,183.70
31	Travel Expense—Atherton Richards to Honolulu .....	130.00
31	Sundries—Stationery .....	1.25
Sept. 4	Fees—Price, Waterhouse & Co.....	17,757.91
8	Sundries—Typewriter Rental .....	2.50
	Sundries—Stationery .....	1.50
	Sundries—Office Supply Co. for calculator .....	10.00
10	Cables for August—Honolulu.....	16.35
17	Expense—C. R. Hemenway—insurance (refunded April 1926).....	10.00
21	Fees—Ford Bacon & Davis—Services of Chas. N. Black as expert witness.....	1,000.00
	Expenses—Ford, Bacon & Davis.....	204.10
	Sundries—Press Clippings .....	5.44
	Expenses—Pillsbury, Madison & Sutro— bill of Sept. 3.....	2,197.99
	Fees—Pillsbury, Madison & Sutro—paid to Edwin Evans Metzger .....	1,000.00
	Fees & Expenses—Atherton Richards.....	7,051.15
30	Cables for Aug.—S.F. ....	21.45
Oct. 6	Cables for Sept.—Honolulu .....	36.50
5	Sundries—Express Charges on documents..	1.93
7	Sundries—drayage on documents .....	1.00
7	Fees—George N. Keystone .....	500.00
	Expense—Pillsbury, Madison & Sutro— bill of Sept. 29.....	1,085.96
	Sundries—Freight on documents.....	1.97
16	Fees—Peat, Marwick Mitchell & Co.....	4,500.00
	Fees & Expenses—Covington, Burling & Rublee .....	1,249.34
	Fees—W. H. Lawrence .....	5,000.00

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-7—(Continued)

23	Sundries—Crating documents—8 packing cases .....	20.00
	Forward.....	\$141,073.55
1925	Forward.....	\$141,073.55
Oct. 31	Sundries—Expressage on documents .....	91.40
31	Fees—W. H. Lawrence .....	20,000.00
31	Fees & Expenses—F. Eberhard Haynes.....	19,512.02
31	Sundries—Expressage .....	2.40
Nov. 7	Sundries—Packing Box .....	.50
16	Fees—Hughes, Rounds, Schurman & Dwight .....	15,000.00
16	Expenses—Hughes, Rounds, Schurman & Dwight .....	343.69
	Expenses—Pillsbury, Madison & Sutro.....	78.95
17	Cables for Sept.—S.F. ....	5.00
Dec. 11	Fees—Real Estate Valuation— Henry Waterhouse Trust.....	500.00
14	Cables—refund to Pillsbury, Madison & Sutro .....	3.68
29	Fees—Royal D. Mead.....	1,500.00
30	Sundries—Expressage .....	3.13
	Total Expenses 1925.....	\$198,114.32
1926		
Jan. 19	Fee—Oscar Sutro—Balance of fee.....	\$100,000.00
Feb. 6	Expense—Pillsbury, Madison & Sutro— Expense of witnesses 12/15/24 to 8/15/25 .....	1,250.00
23	Cables for January—S.F. ....	32.06
26	Expense—Pillsbury, Madison & Sutro— bill of Feb. 4.....	127.20
Mar. 23	Oscar Sutro—Fees .....	50,000.00
	Fees—R. H. Trent .....	5,000.00
Feb. 26	Fees—Pillsbury, Madison & Sutro— refund of Retainer Fee.....	*7,500.00
Apr. 24	Expense—C. R. Hemenway Insurance Refunded paid Sept. 17, 1925.....	*10.00

\* Figures in red.

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-7—(Continued)

5	Expense—Pillsbury, Madison & Sutro— bill of March 25.....	44.00
23	Cables for March—S.F.....	38.95
27	Cables—Honolulu .....	2.90
July 10	Expenses—Pillsbury, Madison & Sutro.....	9.00
24	Expenses—Pillsbury, Madison & Sutro.....	2.66
Aug. 20	Expenses—Pillsbury, Madison & Sutro.....	110.92
Sept. 28	Expenses—Pillsbury, Madison & Sutro.....	5.50
Oct. 13	Expenses—Pillsbury, Madison & Sutro.....	4.11
Total Expenses 1926.....		<u>\$149,117.30</u>

## 1927

Feb. 28	Cables—S.F. ....	\$ 2.00
Mar. 10	Cables—Honolulu .....	46.25
17	Cables—S.F. ....	119.05
Apr. 14	Cables—Honolulu .....	14.20
19	Expenses—Pillsbury, Madison & Sutro— bill of April 7.....	1,825.02
19	Sundries—Press Clippings .....	3.68
21	Sundries—Notary Fee .....	4.00
22	Cables for March—S.F.....	14.80
30	Fees—W. H. Lawrence .....	2,000.00
May 14	Sundries—Press Clippings .....	3.00
16	Fees—Smith, Warren, Stanley & Vitousek..	252.25
26	Expenses—Pillsbury, Madison & Sutro.....	209.99
31	Fees—F. Eberhard Haynes.....	1,738.30
June 22	Expenses—Pillsbury, Madison & Sutro.....	10.45
July 20	Expenses—Pillsbury, Madison & Sutro.....	4.50
	Cables—Message to A. W. T. Bottomley.....	8.00
Total Expenses 1927.....		<u>\$ 6,255.49</u>

## 1928

Mar. 20	Sundries—Express Charges .....	\$ 4.38
31	Expense—Pillsbury, Madison & Sutro.....	5.40
Dec. 24	Expense—Pillsbury, Madison & Sutro.....	2.49
Total Expenses 1928.....		<u>\$ 12.27</u>

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-7—(Continued)

1929

Oct. 26	Fees—Oscar Sutro .....	\$ 10,000.00
Dec. 23	Sundries—Expressage on Books.....	1.75
24	Fees—Smith, Warren, Stanley & Vitousek ( <i>cancelled Feb. 1930</i> ).....	2,539.28
31	Expense—Pernau Welsh Printing Co.....	3,311.80
Total Expenses 1929.....		<u>\$ 15,852.83</u>

1930

Feb. 28	Fee—Smith, Warren, Stanley & Vitousek— charged in error (Dec. 24, 1929) .....	\$ *2,539.28
May 13	Cable .....	10.80
21	Expense—Pillsbury, Madison & Sutro— bill of May 3.....	8.70
Aug. 11	Cable .....	5.70
Sept. 8	Cable .....	10.56
24	Expense—Pillsbury, Madison & Sutro— bill to Sept. 5.....	50.14
Oct. 28	Expense—Pillsbury, Madison & Sutro— bill to Oct. - 8.....	697.95
Nov. 14	Cable—Honolulu .....	5.00
21	Expense—Pillsbury, Madison & Sutro— bill to Nov. 6.....	21.15
22	Expense—Pillsbury, Madison & Sutro— bill to Nov. 13.....	22.00
Total Expenses 1930.....		<u>\$ *1,707.28</u>

\* Figures in red.

1931

Jan. 20	Expense—Pillsbury, Madison & Sutro— bill of Dec. 10.....	\$ 68.45
June 25	Expense—Pillsbury, Madison & Sutro— bill of June 15.....	196.90
July 23	Expense—Pillsbury, Madison & Sutro— bill of July 10.....	63.01
Aug. 20	Expense—Pillsbury, Madison & Sutro.....	10.75
28	Fees—F. Eberhard Haynes—bill of Aug. 15 .....	3,837.29

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-7—(Continued)

Sept. 4	Cables S.F. ....	31.43
Oct. 20	Expense—Pillsbury, Madison & Sutro.....	150.12
Nov. 20	Expense—Pillsbury, Madison & Sutro.....	135.25
Dec. 24	Expense—Pillsbury, Madison & Sutro.....	26.48
Total Expenses 1931.....		<u>\$ 4,519.68</u>

## 1932

Jan. 21	Expense—Pillsbury, Madison & Sutro.....	\$ 8.18
Feb. 25	Expense—Pillsbury, Madison & Sutro.....	5.42
Mar. 17	Expense—Pillsbury, Madison & Sutro.....	7.60
Apr. 21	Expense—Pillsbury, Madison & Sutro.....	5.52
May 10	Expense—Pillsbury, Madison & Sutro.....	53.85
June 22	Fees—F. Eberhard Haynes.....	2,826.39
30	Expenses—Pillsbury, Madison & Sutro.....	15.74
July 21	Expenses—Pillsbury, Madison & Sutro.....	23.60
28	Fee—Oscar Sutro—final fee including that due associates.....	85,000.00
30	Sundries—expressage on exhibits.....	1.15
Aug. 23	Expense—Pillsbury, Madison & Sutro.....	26.69
Sept. 22	Expense—Pillsbury, Madison & Sutro.....	5.06
Oct. 6	Cable .....	13.30
Total Expenses 1932.....		<u>87,992.50</u>

## Recapitulation

Total Expenses 1924.....	\$108,450.65
Total Expenses 1925.....	198,114.32
Total Expenses 1926.....	149,117.30
Total Expenses 1927.....	6,225.49
Total Expenses 1928.....	12.27
Total Expenses 1929.....	15,852.83
Total Expenses 1930.....	*1,707.28
Total Expenses 1931.....	4,519.68
Total Expenses 1932.....	87,992.50
Grand Total.....	<u>\$568,607.76</u>

\* Figures in red.



(Testimony of Sherwood M. Lowrey.)

Q. (By Mr. Wild): Mr. Lowrey, Mr. Cades suggested to me that you hadn't made a full answer to my question as to what discussion there was between American Factors and the group that signed Exhibit 1 annexed to P-5 concerning who would ultimately bear the cost of litigation at the time this organization was set up. [102]

A. For the time being——

Mr. Atherton: Your Honor, I have to object. There is no foundation for that question. The witness has been interrogated with respect to the agreement between the co-defendants other than American Factors, and now he is trying to enlarge without foundation therefor to bring the American Factors into the picture.

Mr. Wild: Well, I am just asking him if there was any discussion.

The Court: Read the last question.

(The reporter read the last question.)

The Court: Well, that is short-cutting quite a bit. Just how is this witness in a position to know?

Mr. Wild: Well, I might ask him that.

Q. As treasurer of American Factors, Limited, was it your duty at that time to have supervision over contracts and agreements between Factors and others? A. It was.

Q. And as a part of that duty, did you make any inquiries concerning what, if any, share of the expense American Factors was to pay at that time on its own account?

(Testimony of Sherwood M. Lowrey.)

A. There was discussion at that time to the effect that, not knowing how the whole thing was going to come out, not knowing when it would be settled, that the question was finally——[103]

Mr. Atherton: His answer goes beyond the question, and the answer must be Yes or No.

The Court: Well, that is true. Ultimately, though, to get anything out of this you will probably have to go into the matter we are dealing with now. The objection is sustained.

Q. Well, did you answer the question that there was some discussion?           A. Yes.

Q. What was that discussion?

The Court: Let's have it a little more definite, the discussion. I can't tell whether it was on the street, in a restaurant or with whom it was. It may have been in the back rooms of the merchandising department. If you are going into some discussion, tell where it was. I'd like to have it particularized a little bit, what kind of a discussion you are talking about.

Q. (By Mr. Wild): You said there was a discussion. About what time was that discussion had?

A. That discussion was had about the time that this agreement was that we made reference to was signed.

Q. Where?

A. For the simple reason that I, as treasurer of the company, I had to have my instructions to know what to do. [104]

(Testimony of Sherwood M. Lowrey.)

Q. And where was this discussion concerning Hackfeld litigation expenses, where did it take place?

A. As I remember, it was either in Mr. Bottomley's office or my office, which was adjacent to his, Mr. Bottomley being the president and manager of the concern.

The Court: Who was carrying on this discussion? I'd like to find out something about the nature, the bonafideness of the discussion and materiality of it. Where does it come in?

Q. (By Mr. Wild): Who were present at the time?

A. Well, in the early stages there there were several present, in the formation of this committee who was going to be the steering committee, as I remember it, most of the time there were the four men present.

The Court: You remember that now from your own personal, direct knowledge, or do you remember it from what you gathered from hearsay here and there? Is it just an impression that you carry or is it based upon some actual absolute knowledge of your own?

The Witness: Knowledge of my own. If I may go into that with you for a minute, I remember very distinctly night after night working on cablegrams that had to be coded. I did them myself.

The Court: I know, but at whose instance, whose cables? [105]

(Testimony of Sherwood M. Lowrey.)

The Witness: That would be the instance of Mr. Oscar Sutró, who was head counsel for the firm, and he in conference with Mr. Bottomley, Cooke and Atherton and Hemenway discussed things in Bottomley's office. Most of the time the door was open. I could hear a large part of those discussions. They would then take out and bring on the long coded messages that had to be sent to the mainland. And Mr. Wirtz, who is now gone, he and I would spend night after night making up these messages. In the morning we'd take these messages or within a day or so they'd be back from the mainland, and we'd have to decode these messages. And I had a very intimate touch with the whole situation.

The Court: That answers very clearly as to the part taken by officers of the American Factors in the litigation, in the course of the litigation, in the management perhaps of the litigation, but it doesn't come back to the question that counsel had in mind as to the relations between this hui—that they were going to put up the money—relations between this hui and American Factors, the corporation, as to any ultimate division or repayment or anything of that sort concerning this cost of litigation.

The Witness: I can explain the instructions that were given to me.

The Court: By whom?

The Witness: Mr. Bottomley. [106]

The Court: Mr. Bottomley was the president of the company?

(Testimony of Sherwood M. Lowrey.)

The Witness: Of the concern.

The Court: Well, I don't want to carry on the examination, but that would seem to be pertinent.

Q. (By Mr. Wild): What were those instructions, Mr. Lowrey?

A. That for the time being I was to keep an absolute track of all the expenses paid out in connection with the Hackfeld litigation; that this group, in accordance with their agreement, were from time to time to be billed as would be agreed upon, an amount to cover each one prorata of the amount of expenses that then stood unpaid for; that the account was to be carried on in that manner and that eventually it would be decided, if the suit had been determined, as to where the ultimate expense of the thing to be borne, as to who would ultimately bear the expense.

The Court: That is Bottomley?

The Witness: Yes.

Q. And those were instructions long prior to the trial of the suit?

A. I forget just when the trial of the suit started. It was all along the line when this group signed this agreement, that that was the way it would be handled.

Q. And it was part of your duties as treasurer of [107] American Factors? You then carried this account, the itemization of which is shown in P-7 on an account in the American Factors books?

A. Yes.



(Testimony of Sherwood M. Lowrey.)

Q. Now, examining that account in the American Factors books——

A. I haven't got a copy of that, unless it is that copy there, if I may use that one.

(The Clerk hands a document to the witness.)

Q. I have asked you to check in this segregation of accounts the various items that were known about in each year. Calling your attention specially to the items——

The Court: Has opposing counsel got a copy of that?

The Witness: I have furnished, as that letter shows on the exhibit, I furnished the Government with altogether eight copies of this thing, your Honor. Mr. Peterson had copies. As this letter shows, we sent two on to them.

Mr. Atherton: Don't you have a copy that you can loan me?

Mr. Wild: Well, this is the last. As I told you when I conferred with you, you have got me down to where I only had one copy left. The Government is about eight to one. Here, maybe we can look at it together. I don't want——

The Court: Well, it is very interesting reading. What is it you want to draw from it? [108]

Mr. Wild: Well, he wanted to see this. I have directed his attention to the items in the year 1932 in that account.

Q. What have you to say as to whether or not

(Testimony of Sherwood M. Lowrey.)

any of the amounts of any of those charges had been fixed prior to the year 1932?

A. Not to the best of my recollection.

Q. Have you looked that matter up? You have looked that matter up, had you not?

A. And, as I remember it, nothing was definitely fixed because they didn't know how long the case was going on or how much of the service would be required.

Q. I see. So that these items that appear for 1932, at the beginning of the year 1932, the amounts, none of them had become definite?

A. Not that I know of.

The Court: Those consist of attorney fees?

Mr. Wild: Yes, your Honor. Some, your Honor will see at the end here, were paid in July of that year, fifty-eight thousand, the final attorney fees, you see.

The Court: What were some frequent payments made to Charles Hemenway? Was he one of the attorneys?

Mr. Wild: I will ask the witness about that.

The Witness: It was felt very necessary in the early part of the stages there to have Mr. Hemenway, who was employed by another concern, to go to the mainland to follow [109] through and see about getting the proper attorneys to handle the defense of this action. And it was felt at that time that Mr. Hemenway should not be asked to do this without compensation. Therefore, arrangements

(Testimony of Sherwood M. Lowrey.)

were made with Mr. Hemenway to take, and in addition to paying the expenses of himself and wife, as the account shows, to take and pay him certain compensation for services.

Q. Was Mr. Hemenway an attorney admitted to practice before the court that you know at that time? A. Yes, he was.

Q. And at that time he was an official of Alexander and Baldwin?

A. I think so. I don't know just to date that, just the date that he severed his law connections and entered A and B. I don't remember.

Q. And the services that he performed were to confer over the facts of this case and bring them to the attention of counsel acting for the defendants, was that it?

A. Yes, on account of his full knowledge of the formation of American Factors, with his legal training it was felt wise to have him up there to confer with the attorneys who were going to represent the defendants in this suit.

Q. Now, as to the principal items that are shown on Exhibit P-7, have you made a statement as to whether or not this so-called steering committee approved those prior to [110] payment?

A. The large items, yes. The small items, it was left up to me. If it was an expense incurred in connection with the litigation, it was perfectly proper for me to take and have those charged

(Testimony of Sherwood M. Lowrey.)

against the litigation expense.- They delegated that power to me.

Q. Now, there was reference made in Exhibit 2 annexed to P-5 to some litigation in New York. Was any part of the expense listed and itemized in P-7 the expense in connection with that litigation in New York referred to?

A. No, that was kept separate under a separate litigation expense account. I remember correctly, it was the Isenberg-Swartz litigation.

Q. But it has nothing to do with the Hackfeld litigation? A. No, it has not.

The Court: Well, there is one reference to it. What was the nature of that litigation? Didn't that involve, the expense of that—

Mr. Wild: No, none of it here—he just testified that there isn't an item of this expense that we claim that was on account of that litigation.

The Court: Where is it mentioned here as to it?

Mr. Wild: New York litigation.

The Court: Yes. [111]

Mr. Wild: In the resolution, which is Exhibit 2 annexed to P-5. You remember, your Honor?

The Court: Yes.

Mr. Wild: And I was showing the fact as to whether or not any of the litigation expense appearing in P-7 was in connection with that suit. And the witness has checked and said No, it has nothing to do with it.

The Court: Yes.

(Testimony of Sherwood M. Lowrey.)

Q. (By Mr. Wild): At the request of counsel have you prepared a copy of the book entries as they appear under Hackfeld litigation expenses showing the reimbursements?

A. Yes, I had that prepared.

Q. And I think I furnished a copy to counsel for the Government.

A. I have a copy here.

Q. This two-sheet one which we furnished at your request. And I told you that I'd put it on. I will ask you what this statement shows, Mr. Lowrey?

A. It shows first the charges in a lump sum, the details of which are already shown in detail in P-7.

Q. Yes.

A. Then it shows the credits setting forth the various amounts that were credited to that account; the principal portion of which, rather the vast majority of it is the payments [112] that were made by the defendants named in the suit, with a few other minor credits that came in in the way of adjustments.

Q. How was that account finally disposed of in the books? Is that shown there? A. Yes.

Q. Do you have a copy of it, another copy?

A. The Judge has it.

Q. Is that the original?

A. That is the original.

Mr. Wild: May we offer the original in evidence?



(Testimony of Sherwood M. Lowrey.)

Mr. Atherton: May I ask you, Mr. Wild, are the books here?

Mr. Wild: No. We will be very pleased to get them.

Mr. Atherton: Do you propose to have the witness testify just how this is treated on the books, what account it is charged to, and so on?

Mr. Wild: I would ask him to, yes. I didn't understand that counsel wanted the books here. We told him that they are available, and the revenue office, as your Honor knows, sends a man down and checks everything. And I was going to ask him about these. As a matter of fact, I am doing this because I promised Government counsel I'd bring it out.

Mr. Atherton: Well, I merely wanted to be sure that you are not just going to stop when you offer this statement. [113] I want more information about the statement in the record.

Mr. Wild: And you'd be privileged naturally to ask any question on cross.

Mr. Atherton: Lay the foundation for it by developing how it was all charged, and so forth. You see, it is not informative, your Honor, as it stands. It is headed "Hackfeld Litigation" and debits and credits, and doesn't show what account it was charged to, whether it is an expense account, profit or loss account, reserve account, or what have you, so I want the record to show that as a pre-

(Testimony of Sherwood M. Lowrey.)

requisite to the admissibility of this statement in evidence.

Mr. Wild: This is, as I understand it—he testified to it as an abstract of an account in the American Factors’ ledger known as the Hackfeld litigation.

The Court: I think that the objection, the insistence that it isn’t the best evidence, must be sustained.

Mr. Wild: Well, I asked him, your Honor, if he wanted the books and he said No.

The Court: Well, now he apparently says he does.

Mr. Wild: Do you want the books?

Mr. Atherton: Well, I feel this way, your Honor: I don’t want to cause the taxpayer any inconvenience.

Mr. Wild: No inconvenience about it. We would have them up here.

Mr. Atherton: Have the record show now, explain more [114] in detail what this account is on the books, how it was set up, and if that is satisfactory then we won’t need the books. But just submitting a statement saying “account of the books” doesn’t convey any information at all.

The Witness: I can explain that.

Q. (By Mr. Wild): Very well. May I ask you about this account?           A. May I have that?

Q. Explain it, how it is set up on the books and what books it was from?

(Testimony of Sherwood M. Lowrey.)

A. We set up in the general ledger of American Factors, Limited, an account entitled "Hackfeld Litigation." Against that account we charged all payments made in connection with litigation expenses. We credited against that account any amount of money that came in, such as the payments made by these 22 respondents, and anything else that may have gotten charged, we will say, to the error, as I notice in here. There's one or two little ones, a refund of a ticket that had been charged in error; so that all the outgo and all the income during that whole period of years was carried under the one account, Hackfeld litigation. At the end——

Mr. Atherton: Excuse me a minute. May I ask a question to clarify it?

Mr. Wild: Oh, yes.

Mr. Atherton: Was that a memorandum account? [115]

The Witness: No, in the general ledger.

Q. (By Mr. Atherton): I don't want to argue, but will you say that you carry in your ledger, general ledger accounts, memorandum accounts?

A. I believe there is one memorandum. If you and I mean the same thing now by memorandum account. I believe there is one thing in there that has certain things to do about possibly invested capital that has been written off the books, which is kept in there as a memorandum only in order that it can be used for tax purposes, like organiza-

(Testimony of Sherwood M. Lowrey.)

tion expense. That was all written off. And still it is part of the invested capital. I think there is such an account there.

Q. Well, how do you close out this account, this so-called account?

A. All right. This account was kept open until such time as the determination had been made as to who was to bear the final cost. At that time, it was in 1932, there was a balance in the general reserve account which was carried over from Hackfeld and Company that had a credit to it of \$541,237.79. That amount of litigation expense was charged against that reserve to wipe it out. That was the reserve, you will note, that has been from statements made in this Courtroom here, was the reserve created to cover any undisclosed liabilities of Hackfeld and Company. We then needed [116] \$27,369.97 to wipe out and make up the balance of the cost of the litigation, which was \$568,000 odd. That twenty-seven thousand was charged against earned surplus.

The Court: Against what?

The Witness: Earned surplus.

The Court: That is earnings of a corporation, of American Factors?

The Witness: Yes.

The Court: Set up a surplus account from the end of the first year?

The Witness: Yes, what some corporations call their undivided profit account; we call it the earned surplus account.

(Testimony of Sherwood M. Lowrey.)

The Court: Well, the Factors had begun to set up such an account towards the end of their first year of operation?

The Witness: Yes, sir. In other words, the profits for the year which were not paid out in dividends went to the earned surplus account, and each year thereto the profits not paid out were added to the earned surplus account, and each year thereto the profits not paid out were added to the earned surplus account.

The Court: So after wiping out the Hackfeld surplus account you went into your own to the extent of twenty-seven thousand?

The Witness: Twenty-seven thousand dollars, yes, sir.

Q. (By Mr. Wild): But all of the assets offset against that reserve [117] in the Hackfeld litigation account belonged to American Factors, didn't they?

A. Yes. That was the balance between the value, the net value of the assets; in other words, the gross value of the assets less the outstanding liabilities was a certain figure; your capital stock which was paid for was seven and one-half million; the difference between the net value of your assets and the seven and one-half million was this reserve which, as I remember it, was around seven hundred thousand dollars. But prior to 1932 there had been certain undisclosed liabilities showed up which had been settled and charged against that reserve which had



(Testimony of Sherwood M. Lowrey.)

reduced it then down to whatever this balance figure was, 570,000. That is as I remember it.

Mr. Wild: We would offer this statement in evidence and ask that it be marked as P-8.

The Court: Did you keep any ledger account with these different individuals here?

The Witness: No, did not, sir.

The Court: So these were all cash transactions?

The Witness: Yes, sir. In other words, I'd figure it out this way, that when, we will say, \$75,000 of expenses had incurred, and there were \$25,000 of shares involved in this, ownership by these people, I'd go to Mr. Bottomley and say, I think we had better get some money in on this. How [118] much do they owe us? Well, we have advanced \$75,000. I'd suggest that we levy an assessment, if you want to call that, or ask them to contribute at the rate of three dollars per share; three dollars per share times the 25,000 outstanding shares would bring the \$75,000 in.

The Court: Well, this debt, this is what you had expended?

The Witness: Yes, sir, during the year.

The Court: And you made collections from these different persons who belonged to the hui?

The Witness: Yes, sir.

The Court: Now, at the end, what did you collect from Sherman?

The Witness: Because they paid, and you will note these collections came in late in December of

(Testimony of Sherwood M. Lowrey.)

1925. These four gentlemen or three gentlemen, Sherman, Bottomley and Welch and Company paid in the first few days of January. In other words, these remittances——

The Court: Pillsbury?

The Witness: Pillsbury—it should be Madison and Sutro. They sent in 75. There had been an overpayment to them on their account of seventy-five hundred dollars.

Mr. Wild: Your Honor, I think this is a noteworthy occasion and if the hour of four is a proper hour to adjourn, I think it calls for a celebration.

The Court: Well, this now is offered in evidence without any objection?

Mr. Atherton: Yes, your Honor, but I'd like to ask him some questions.

The Court: Before it is received?

Q. (By Mr. Atherton): Will you tell me whether or not Mr. Bottomley directed you to carry these litigation expenses in a suspense account?

A. Yes. In talking it over, whether he told me to do it or I suggested to him that that would be the proper way that it was done, I don't know. But that was the way that it was done. You see, we are going back here now to 1924.

Q. Would you say that these entries here on this exhibit really reflect more or less adjustment entries, adjustment entries, just bookkeeping adjustments?

A. I don't know the term "adjustment entries."

(Testimony of Sherwood M. Lowrey.)

Q. Well, to adjust.

A. These are actual entries. These are copies of actual entries in the books.

Q. Were they not entered on the book to give effect to past transactions?

A. No, because they are entered on the book as the payments were either made or the receipts came in. Most of [120] those entries would naturally, a large portion would go right straight through the cash books.

Q. By payment made, what do you mean by that statement? Payment made by whom?

A. Well, payment made by American Factors on behalf of the group. Take your first one, if you wish.

Q. That's all right.

Mr. Wild: Let him finish it.

A. The first one, Mr. Wirtz, working at night, a heavysset man, no means of communication, probably midnight or after that, hired an automobile to go home; reimbursement to him; travel expenses, Mr. and Mrs. Hemenway to San Francisco.

Q. I am talking about this last exhibit.

A. You are talking about receipts? I thought you were talking about payments. I am looking at the payments.

Q. This is a summary of the payments, is that right?

A. That is a summary of the account which is

(Testimony of Sherwood M. Lowrey.)

the receipts or the payments made by the individuals to American Factors.

Q. I see.

Mr. Wild: May that be marked "P-A" for identification so that that record will be clear on it?

The Court: Well, what I am wondering about is, there is an account of the Hackfeld litigation, but this isn't an account. Where did you keep those other accounts that [121] make up the P-7? Why aren't they all in the same account if it is an account of the litigation?

The Witness: They were—it was for this reason: The Internal Revenue Bureau had asked for the list of the expenses. That had already been submitted. And in order to get a complete—the other day when I knew I was going to be a witness here, I requested them to make up a memorandum of the receipts. The two could be combined very easily, if it would be of assistance.

The Court: And they are in the books?

The Witness: They are taken right from the books of the company.

The Court: So that these items would flow all the way through that in order to make up the 108 or 9 that you start with there?

The Witness: Yes, sir.

The Court: Well, I don't know that there is so much quarrel about the detail of these accounts. The main thing is as to the applicability under the law of the account.

(Testimony of Sherwood M. Lowrey.)

Mr. Wild: Yes.

Mr. Atherton: Well, what I am trying to establish, your Honor, is whether this was charged to profit and loss or to the general reserve.

Q. (By Mr. Atherton): As I take it, you have testified that this was [122] charged to a general reserve, and the balance to and under surplus account, and no part of it was charged to profit and loss?

A. No, sir.

Q. Never into profit and loss? A. No, sir.

Q. And when they closed out the account, they closed through surplus, isn't that correct?

A. Closed to that general reserve which was the so-called balance of the Hackfeld reserve and used all that, used all that up. The balance that was then still outstanding on this, to clear this Hackfeld litigation account, was charged to surplus or to earned surplus. And thereby the Hackfeld litigation account was wiped off the books, the Hackfeld reserve was wiped off and your earned surplus had been reduced by 27,000.

Q. You have stated, I believe for the record, how this other reserve was created as an excess of the value of the assets over the liabilities of the old Hackfeld Company, is that right?

A. That is right, as I remember it. I was not treasurer of the company at that time. In fact, when it was formed in 1918 I was not with the company. But that is my recollection. And then it must be also borne in mind that during the first



(Testimony of Sherwood M. Lowrey.)

seven months of 1918 Hackfeld was a going concern and presumably [123] had made some profit. And they had to set the thing up in their books as of the closing date. So it was the difference between the assets and the liabilities. And if I remember it, possibly the bureau, the men from the bureau behind you could tell you: But I think it was somewhere around seven hundred thousand. But I don't know. It could be ascertained.

Mr. Wild: If it is important, we will have the exact dollars tomorrow, your Honor.

The Court: You mean that after this hui that organized the plan to take over Hackfeld they took it over and operated it as Hackfeld and Company before the formation and organization of the American Factors?

The Witness: No, sir.

The Court: There was a time in there after Hackfeld——

The Witness: One moment. That Hackfeld and Company ceased to operate and the title passed to American Factors.

The Court: Immediately?

The Witness: Yes, right there. It had to be done. You couldn't operate under the two companies. Title either had to be in Hackfeld and Company or it had to be in American Factors. And at that time there was about seven hundred thousand dollars more assets than the capital stock. And,

(Testimony of Sherwood M. Lowrey.)

as shown later, there were undisclosed liabilities of Hackfeld that had to be taken care of. [124]

Mr. Wild: May I ask these questions?

Q. (By Mr. Wild): At the precise time, to wit, July 20, 1918, that the assets and businesses of H. Hackfeld and Company, Limited, were conveyed to American Factors, at that precise time the assets of H. Hackfeld and Company were evaluated per books, and the liabilities were determined per books, the excess of liabilities or the excess of assets over liabilities was something like \$700,000?

A. No.

Q. Well, will you explain it?

A. It was more than that. It was greater. It was more than seven and one-half million. Wait a second. Maybe I misunderstood you.

Q. The assets exceeded the liabilities, including the capital stock?

A. Oh, if you include the capital stock, by somewhere around \$700,000, as I remember it.

The Court: Seven what?

The Witness: Seven and one-half million.

The Court: That was Hackfeld capital stock?

The Witness: That was what American Factors paid Hackfeld and Company for their going business.

Mr. Wild: You see, actually on the books the net value of assets of H. Hackfeld and Company at that time was about [125] \$8,200,000 odd. American Factors paid \$700,000 for those assets. They set up

(Testimony of Sherwood M. Lowrey.)

capital, seven hundred thousand; capital, seven million and one-half, surplus seven hundred thousand; to make up the difference between the value of assets and the capital, then isn't that what was done?

The Witness: As I remember it.

The Court: Capitalized for five million?

The Witness: Five million, correct. But the stock was sold at \$150 per share. Therefore, the actual account was five million capital, two and one-half million paid in surplus, and then this seven hundred thousand in addition thereto.

Mr. Atherton: Your Honor, I think I could probably clarify this better after, tomorrow, after they bring in the books, to show how that account was originated in the books.

The Court: All right, you offered to do that.

Mr. Wild: May I ask a question? At present, Mr. Lowrey being retired, is not an officer of American Factors. He therefore does not have the custody of the books. Will you make any objection on the ground that they should be presented and identified by a proper officer of American Factors?

Mr. Atherton: No.

Mr. Wild: Because if you do, I will bring up the treasurer or secretary and he will bring them. So that if Mr. Lowrey brings them up, you won't make any objection? [126]

Mr. Atherton: No.

Mr. Wild: May I ask another question? About

(Testimony of Sherwood M. Lowrey.)

how long do you think you will be with Mr. Lowrey on cross-examination?

Mr. Atherton: Well, I can't tell. I want to think it over tonight as to some of the questions I might want to ask him. It might be 15 or 20 minutes more.

Mr. Wild: I mean, it would run a half hour——

Mr. Atherton: I may not ask him any questions after the books clarify themselves. But I can't tell. I want to deliberate on it.

Mr. Wild: Very well. Could I find out tomorrow? The only reason I am asking is because I don't want to keep any other witness,—I haven't any on this end of the case—I don't want to keep any other witness hanging around here unless we have to. That's all. I think I will be through with Mr. Lowrey in probably half or three-quarters of an hour more.

Mr. Atherton: I think so, too.

The Court: Well, I was going to ask you, you prefer to start at ten o'clock?

Mr. Wild: I do, your Honor.

Mr. Atherton: That is agreeable to me, your Honor.

Mr. Wild: It gives us a chance to call these other fellows:

The Court: It gives the Court a chance to run some other [127] business along.

Mr. Atherton: Are we going to have an afternoon session tomorrow?

(Testimony of Sherwood M. Lowrey.)

The Court: It looks as if we will have to.

Mr. Atherton: I'm anxious to get the case over.

The Court: So am I. I've got all next week tied up with criminal jury trials and I don't want to interfere with that if I can possibly help it. These two books here, you have submitted them to me but you also submitted a memorandum pointing out what you wanted to refer to here, so they haven't been put in evidence.

Mr. Wild: Oh, no, your Honor. I just brought them up. I thought your Honor might want to read them. But I've got to digest them.

The Court: I will pass them to the clerk to just hold them as custodian.

Mr. Wild: I thought your Honor might just like to go over them, the originals, but I have given copies to your Honor. Now, on this exhibit P-8, has that been received in evidence as yet?

The Court: No, because if we are going to get the books here, and they have been asked for and they will be brought in the morning, why, I don't want to settle the book account by putting these in now.

Mr. Wild: Well, your Honor, might I say this: The [128] Government asked for the item of expenses which was selected from this account. Now, the other side, the reimbursements to the account, you see, wasn't asked for. So they weren't in there.

The Court: I understand.

Mr. Wild: So that these two accounts together make up what the books show.



(Testimony of Sherwood M. Lowrey.)

The Court: You understood and meant to furnish everything that you thought was needed. But now the question arises in opposing counsel's mind as to just what this set-up was on the books and he wants to see the books, and that, of course, is the best evidence. So if you will bring those in tomorrow, we will have it. This case is continued until tomorrow morning at 10 o'clock.

(The Court adjourned at 4:15 p.m.) [129]

November 13, 1947

(The Court convened at 10:00 a.m.)

The Clerk: Civil No. 419, American Factors, Limited, versus Fred H. Kanne, Collector of Internal Revenue; case called for further hearing.

Mr. Wild: Ready to proceed for the Plaintiff. Mr. Lowrey was on the stand. I would ask that he be temporarily withdrawn so that another witness may take the stand briefly to prove ledger statements.

HAROLD C. EICHELBERGER

a witness in behalf of the Plaintiff, being duly sworn, testified as follows:

Direct Examination

By Mr. Wild:

Q. Will you state your name, Mr. Eichelberger?

A. Harold C. Eichelberger.

Q. And where are you a resident?

(Testimony of Harold C. Eichelberger.)

A. In the Territory of Hawaii. My home is in Kailua.

Q. That is on the Island of Oahu?

A. Island of Oahu.

Q. What is your present position with American Factors, Limited?

A. I am assistant treasurer and assistant secretary [130] of the company.

Q. As such officer of the company, you have under your custody and control the books of accounts of the company?      A. I do.

Q. Have you produced here two accounts at my request?      A. Yes, I have.

Q. And what are those accounts?

A. I have here the ledger sheets containing the record of the Hackfeld litigation expense account and of the general reserve account.

Q. And those are the sheets that you have there presently?      A. That's right.

Q. And what are they numbered?

A. Each card of the ledger is given a number one as it started out each year, and, for instance, the first ledger card of the Hackfeld Litigation expense account is numbered one, started in 1924, continued on the back 1-A, and continued to a second card No. 2, and in which the balance then on the second card is the balance at the end of the year, and carried forward to the next year, card numbered one beginning January 1, 1925.

Q. Very well. And so on through?

(Testimony of Harold C. Eichelberger.)

A. Yes, and so on through.

Mr. Wild: I don't want to offer these in evidence, may [131] it please the Court. May I have them just marked for identification now as P——

The Court: Well, perhaps if you offer them for examination and may be able to substitute——

Mr. Wild: Exhibits for them?

The Court: Yes.

Mr. Wild: Yes, your Honor. That's what I wanted to do, because we had them merely today, as I understood, for check. May I withdraw this witness now, leaving the sheets here in the custody of the Court at present, and put Mr. Lowrey back on the stand?

The Court: Yes. I assume that is satisfactory.

Mr. Atherton: Before you do, I just wanted to ask the witness a question. I think he testified, your Honor, that he has ledger cards with respect to the reserve they are talking about to which these Hackfeld litigation expenses were charged. Was there no book of original entry showing that reserve carried over from the books of the Hackfeld Company?

Mr. Wild: Well, I am going to object to this. Counsel asked yesterday for the ledger reserve. May I state for this record that representatives of the Internal Revenue Bureau went down and they have gone all through these records. Counsel knows everything that is in them. He gave copies to them.

Mr. Atherton: This is a De novo proceeding, and counsel should understand that. And it is up to him

(Testimony of Harold C. Eichelberger.)

to prove his case as it goes along, regardless of what was submitted to the Bureau of Internal Revenue or any other Government officials prior to this suit. Now, the Government insists upon determining whether or not there was any book or books of original entry showing the carry-over from the Hackfeld Company, the so-called reserve against which these litigation expenses were charged. These books are secondary books, the ledgers?

The Witness: This is a primary record.

Mr. Atherton: Primary record?

The Witness: The ledger record.

Mr. Atherton: It is a ledger record?

The Witness: Yes.

Mr. Atherton: But it is a subsidiary book.

Mr. Wild: Your Honor, counsel just seems to be arguing with the witness. The witness told him it is a primary record.

The Court: Well, he said primary record. I get the point of course that everything in the ledger originated from some other source, either through the cash book or journal or some other account. That is what I understand counsel is inquiring about, and I don't know whether you expressed a desire to see those accounts or not. [133]

Mr. Atherton: What I wanted, your Honor, was to show the Court what the descriptive journal entry was on the book, original entry, where they reflected transfer of the setting up of this so-called reserve account to which these expenses were charged. Now,

(Testimony of Harold C. Eichelberger.)

I understand that the ledger entries showing the detail in the charge of the litigation expenses is for all purposes a book of an original entry here, because it is comparable to a day book. But when it comes to the account in which those entries were actually closed out eventually, that account was carried over, as I understand the testimony of Mr. Lowrey, from the books of the Hackfeld Company.

Now, I want to see what entries, what opening entries are made on the books of the taxpayer to record that transfer over.

The Court: I'd assume you'd have to see the journal entry, too, to get that. Is that not so?

The Witness: The first entries on this general reserve account are by journal entry, yes, are from the journal posting.

Mr. Atherton: Well, it is the journal posting what I'd like to see, what the journal showed as to setting up of that reserve. Do you happen to have that with you?

The Witness: I don't have the journal itself, no.

The Court: You can get it? [134]

Mr. Wild: Do you have a transcript of the journal entry?

The Witness: I have a transcript.

Mr. Wild: Which you prepared at my request?

The Witness: Yes.

Mr. Atherton: That will be satisfactory, your Honor.



(Testimony of Harold C. Eichelberger.)

Q. (By Mr. Wild): And do you have that transcript of the journal entry there with you?

A. I do.

Q. And what does that transcript show?

A. The original entry in account—do you want me to read it?

Q. No. You will identify that as an original, 'as a transcript of the entry? A. Yes.

Q. Were you treasurer or assistant treasurer of the company at that time? A. I was not.

Mr. Wild: We have here Mr. Lowrey who was the treasurer of the company at that time, and I called this witness to identify the records, and I'd like to withdraw this witness and put Mr. Lowrey on the stand. But he can go ahead and read this.

Mr. Atherton: I have no objection. It is perfectly [135] all right.

Mr. Wild: I was just getting the proper witness.

Mr. Atherton: I won't challenge his competency.

Q. (By Mr. Wild): Will you read that journal entry?

A. The first entry is dated December 31, 1918, journal folio 1604. The entry reads, "Debit, H. Hackfeld and Company, Limited, \$11,525.18; credit, special reserve account, \$11,525.18." The explanation furnished for that is book profit accruing to American Factors, Limited, on book balance of net assets purchased from H. Hackfeld and Company, Limited, as follows: assets as of January 1, 1918, \$13,675,504.21. Deduct liabilities as of January 1, 1918, \$5,750,510.43. Reserve for depreciation, \$413,-

(Testimony of Harold C. Eichelberger.)

468.60. Brought across is \$6,163,979.03, which subtracted from the assets of \$13,000,000 odd leaves \$7,511,525.18. Less capital stock issued of \$7,500,000. Difference, \$11,525.18.

Q. And the second journal entry?

A. The second journal entry is also dated December 31, 1918, folio 1605. Debit, H. Hackfeld and Company, Limited, \$733,898.27. Credit, special reserve account, \$733,898.27. The explanation given: additional book profit on book value of assets of H. Hackfeld and Company, Limited, as of August 20, 1918, purchased by American Factors, Limited.

Mr. Wild: No further questions. [136]

Mr. Atherton: No questions.

Mr. Wild: I will introduce the sheets in evidence for the convenience of the Court, and I will ask that the two be fastened together and marked as P-8.

The Court: Very well.

The Witness: I have these in duplicates.

Mr. Wild: Well, the original will be introduced in evidence.

The Court: That is Exhibit P-8?

Mr. Wild: Yes. I think that I asked this other exhibit that we were arguing about at the last session be marked P-8 for identification. And if that comes in, it should come in, I think, as P-8. So may this be marked as P-9?

(The documents referred to were received in evidence as Exhibits P-8 and P-9.)

(Testimony of Harold C. Eichelberger.)

## PLAINTIFF'S EXHIBIT P-8

## Hackfeld Litigation

Year	Dr.	Cr.	
1924	108,585.65		
Nov. 24	C. G. Heiser ticket.....	135.00	
Dec. 17	C. Brewer & Co.....	10,350.00	
	Alexander & Baldwin .....	10,350.00	
	H. P. Baldwin, Ltd.....	10,350.00	
	A. W. T. Bottomley.....	4,500.00	
	G. P. Wilcox.....	2,250.00	
	G. N. Wilcox.....	8,325.00	
	R. A. Cooke.....	112.50	
	F. J. Lowrey.....	2,250.00	
	C. M. Cooke, Ltd.....	4,500.00	
	George Sherman .....	4,162.50	
	E. D. Tenney.....	450.00	
	Castle & Cooke, Ltd.....	10,350.00	
	F. C. Atherton.....	1,125.00	
	J. B. Atherton Est.....	2,700.00	
	S. W. Wilcox.....	4,162.50	76,072.50
1925	198,114.32		
Aug. 15	C. Brewer & Co.....	8,050.00	
	Alexander & Baldwin .....	8,050.00	
	H. P. Baldwin, Ltd.....	8,050.00	
	Wm. Alexander .....	5,736.00	
	Alexander Prop. Co. ....	1,664.00	
17	W. F. Dillingham.....	600.00	
18	C. M. Cooke, Ltd.....	3,500.00	
19	Grove Farm Co., Ltd.....	6,475.00	
21	Castle & Cooke .....	8,050.00	
	F. C. Atherton .....	875.00	
	J. B. Atherton Est.....	2,100.00	
24	S. W. Wilcox.....	3,237.50	
25	G. P. Wilcox .....	1,750.00	
27	A. W. T. Bottomley.....	3,500.00	
Sept. 1	Matson Navigation Co.....	18,400.00	
	W. P. Roth.....	800.00	
	Andrew Welch .....	800.00	
8	Welch & Co.....	18,400.00	
	E. D. Tenney.....	350.00	
	R. A. Cooke .....	87.50	
Oct. 3	Geo. Sherman .....	3,237.50	
31	F. J. Lowrey.....	1,750.00	
	Forward.....	306,699.87	105,462.50
			76,072.50

(Testimony of Harold C. Eichelberger.)

## Hackfeld Litigation (Continued)

Year		Dr.	Cr.	
1925	Forward.....	306,699.97	105,462.50	76,072.50
Dec. 17	Alexander & Baldwin .....		21,850.00	
	H. P. Baldwin, Ltd.....		21,850.00	
	W. M. Alexander .....		6,811.50	
	Alexander Prop. Co.....		1,976.00	
	C. Brewer & Co.....		21,850.00	
	E. D. Tenney.....		950.00	
18	R. A. Cooke .....		237.50	
	W. F. Dillingham.....		712.50	
	F. C. Atherton.....		2,375.00	
	J. B. Atherton Est.....		5,700.00	
21	F. J. Lowrey .....		4,750.00	
	Castle & Cooke .....		21,850.00	
	G. N. Wilcox .....		17,575.00	
31	S. W. Wilcox.....		8,787.50	
	C. M. Cooke, Ltd. ....		9,500.00	
	Matson Nav. Co.....		21,850.00	
	W. P. Roth.....		950.00	
	Andrew Welch .....		950.00	275,987.50
1926	.....	156,627.30		
Jan. 5	George Sherman .....		8,787.50	
4	A. W. T. Bottomley .....		9,500.00	
19	Welch & Co.....		21,850.00	
Feb. 26	Pillsbury, W. & S.....		7,500.00	
Apr. 24	Refund on Bond premium.....		10.00	47,647.50
1927	.....	6,255.49		
Apr. 30	G. P. Wilcox.....			4,750.00
1928	.....	12.27		
1929	.....	15,852.83		
1930	.....	832.00		
Feb. 28	Fee of Smith, Warren, etc. charged in error 12/24/29.....			2,539.28

(Testimony of Harold C. Eichelberger.)

Year	Dr.	Cr.
1931 .....	4,519.68	
1932 .....	484,805.00	
	<u>975,604.54</u>	<u>406,996.78</u>
Less credit .....	406,996.78	
	<u>568,607.76</u>	
Charged out as follows:—		
General Reserve .....	541,237.79	
Earned Surplus .....	27,369.97	
	<u>568,607.76</u>	

## PLAINTIFF'S EXHIBIT P-9

12/31/18—J 1604

H. Hackfeld & Co., Ltd.....	11,525.18	
Special Reserve Account.....		11,525.18
Book profit accruing to American Factors, Ltd. on book balance of net assets purchased from H. Hackfeld & Co., Ltd., as follows:—		
Assets as of 1/1/18 .....		13,675,504.21
Deduct Liabilities as of 1/1/18.....	5,750,510.43	
Reserve for Depreciation.....	413,468.60	6,163,979.03
		<u>7,511,525.18</u>
Capital Stock Issued.....		7,500,000.00
		<u>11,525.18</u>

12/31/18—J 1605

H. Hackfeld & Co., Ltd.      }		
Special Reserve Account    }		733,898.27
Additional Book Profit on book value of assets of H. Hackfeld & Co., Ltd. as of August 20, 1918 purchased by American Factors, Ltd.		



(Testimony of Harold C. Eichelberger.)

Mr. Wild: Now I'd like to withdraw this witness.

Mr. Atherton: No examination.

Mr. Wild: I'd like to have him leave these sheets in the custody of Mr. Lowrey. Thank you.

(Witness excused.)

Mr. Wild: Mr. Lowrey, will you take the stand?

SHERWOOD M. LOWREY

a witness in behalf of the Plaintiff, having previously been sworn, resumed and testified further as follows: [137]

Direct Examination

(Continued)

By Mr. Wild:

Q. Mr. Lowrey, there has been identified as coming from the custody of the company certain ledger sheets. Have you ever seen those before? (Handing exhibits to the witness.) A. I have.

Q. And are there the original entries showing the Hackfeld litigation expense there in the journal or in the ledger?

A. These are the original ledger cards.

Q. I see. And will you explain them to the Court?

A. I take it that the Court naturally is familiar with a ledger sheet. These cards here are simply the compilation, the compilation of the items that are charged to that account, and the items that in turn

(Testimony of Sherwood M. Lowrey.)

are credited to it, which takes and shows the entire transaction in a summary form, as indicated on the card.

Q. And I will show you the items in a copy of P-7 already adduced in evidence, and I will ask you if that P-7 is an accurate copy of one column of the cards and if so, what column?

A. With a hasty glance over here, I can see on this sheet here where there is one entry guided to this account incorrectly and has been taken out, with the exception of [138] a possible error like that which did not pertain to the Hackfeld litigation expense here, I feel confident that it is because this exhibit which I now have before me was made up by the chief accountant of the company and I presume after being typed was compared and is correct.

Q. Which column does that show?

A. This one that I now have.

Q. Yes, P-7.

A. That is the debit side. That is the charges.

Q. The debit side of the account, the charge side of the account?

Mr. Wild: I might say this: Does Counsel make any question of the correctness of the transcription of those items into P-7?

Mr. Atherton: We do not, your Honor. We have allowed that exhibit to go in without any objection.

Mr. Wild: So that counsel has checked these?

(Testimony of Sherwood M. Lowrey.)

Mr. Atherton: I am satisfied as to its correctness.

Mr. Wild: Now, I would ask that those be exhibited to the Court. But now I will ask for Exhibit P-8 for identification. I think the clerk has it there. Or was it returned to me?

The Clerk: You have it, Mr. Wild. I returned it to you last night.

Mr. Wild: Well, I had asked last night that P-8 be [139] marked for identification, that this be marked P-8 for identification.

Q. I will show you P-8 for identification and I will ask you to compare it with the original sheets now in the possession of the Court and state whether or not it is a correct transcript of items appearing on the account under heading of Hackfeld litigation expense? I think you have to look at the ledger sheets.

The Court: Pardon—go right ahead.

Mr. Wild: I want him to compare them.

A. It is practically the same as these cards.

Q. Well, what do you mean by “practically?”

A. There are one or two little things that apparently, as I mentioned—an error had been made which had been eliminated from the transcript in order to make this data which had been submitted in this memorandum form as clear as possible without having those errors show up in it. So far as I can see, the credits have been handled in a similar manner.

(Testimony of Sherwood M. Lowrey.)

Mr. Wild: Does counsel want to inspect them?

Mr. Atherton: No, I had them in front of me and I had been inspecting them. Just as a matter of information to the Court, I can't reconcile the two arithmetically. But I think for the purpose of the record I will accept the statement of Mr. Lowrey that the impossibility of reconciling of these two is due to the adjustment of the entries that [140] he has been talking about. We are not challenging that.

The Court: They both come out the same?

The Witness: The net will come out the same, your Honor.

The Court: I was just wondering what an item of dry goods, how that entered into the litigation?

The Witness: It is very possible that it was something from the dry goods department which handled the paper. It may have been that paper used by something in connection with drawing up exhibits or typing or something like that that had been charged into this account, because when the dry goods department gave it up they had to account for it to somebody. It was their property. Therefore, they charged it out to somebody. I say, I presume it could have been something like that. It could have been carbons. It could have been pencils. It could have been ink. It could have been any kind of stationery. I don't know to which item you are referring. That is the general explanation.

(Testimony of Sherwood M. Lowrey.)

Q. Mr. Lowrey, what column does P-8 show in that ledger account?

A. This shows the credits, subject to my former remarks.

Q. Yes. That is the credits, as I understand it; in P-8 they are the same as the credits in the ledger account after adjusting for erroneous entries? A. Correct. [141]

Q. In the ledger account? And in the P-8 on the debtor side, the figures that appear there, what are they?

A. They are simply the total of the expenses as shown in the exhibit. I think it was P-7.

Q. Yes.

Mr. Wild: We will offer P-8 in evidence, your Honor.

The Court: Any objection?

Mr. Atherton: No objection, your Honor.

The Court: Describe P-8. It is the summary transcript of the ledger account?

The Witness: It would be the summary as far as the debit is concerned but shows the credits in detail.

The Court: What do you call it?

Mr. Wild: I would think it is a condensed transcript. Is that an accurate statement, Mr. Lowrey? I am not trying to lead you. That P-8 is a condensed transcript of the credit account in the Hackfeld litigation expense?

The Witness: Yes.



(Testimony of Sherwood M. Lowrey.)

Q. The account as shown in the American Factors' ledger, is that correct?

A. Yes, a condensed statement. That covers the elimination of one or two items in there.

Q. And also it condenses the one figure on the debit side for the year, that is understood?

A. Yes. [142]

Mr. Cades: Condensed transcript of the Hackfeld litigation expense.

Mr. Wild: Mr. Cades has a better suggestion. I will ask him to make it to the Court. He is not only an attorney at law but concerned——

Mr. Cades: I'd suggest we call it the condensed transcript of the Hackfeld litigation expense account.

The Court: I just want some term to identify the exhibit in my notes. I got it.

Q. (By Mr. Wild): Now, Mr. Lowrey, you have there——

Mr. Wild: I will ask to withdraw the ledger sheets at this time and return them to the custody of—or if the Court desires to examine them further—does the Court desire to examine the original ones?

The Court: No, I don't have any desire.

Mr. Wild: As I understand it, we are not making any issue of any of the items in there except as they had been shown in either P-7 or P-8.

Mr. Atherton: That's right. No objection to withdrawing them, your Honor.

The Court: Very well.

(Testimony of Sherwood M. Lowrey.)

The Witness: The general reserve also.

Mr. Wild: Now, the general reserve account——

The Court: Submit it merely for inspection. The inspection, [143] as I take it, was made.

Mr. Wild: Now, we have produced these other accounts for examination by counsel for the Government, because the opening account is shown in P-9; closing account is shown in this exhibit P-8 where the Hackfeld litigation expense was charged off to reserve, general reserve, \$541,237.79. And then earned surplus, \$27,000. In other words, the closing out of this ledger account is shown on P-8, which is in evidence, so that the opening entry and the closing entry is shown. Does counsel for the Government desire any more inspection of those?

Mr. Atherton: No more inspection.

The Court: Well, all of that reserve, Hackfeld reserve account, was set up after the Factors took over, by reason of revaluation or something, is that so? Or did they, did the Factors inherit, so to speak, did the Factors inherit it? Was that account on Hackfeld books when the Factors took it over?

The Witness: That I cannot say. I was not treasurer of the company at that time. All I have to go on is what these records show.

The Court: Well, the dates would——

The Witness: And these records show here that they made certain adjustments, as has been explained by Mr. Eichelberger, as of the end of the year, December 31st, when the entry——[144]

(Testimony of Sherwood M. Lowrey.)

The Court: 1918.

The Witness: As of August 20th, I believe.

The Court: Well, did the Factors take over——

The Witness: August 20, 1918.

The Court: Well, up until that time the affairs, the management of the company had been where?

The Witness: In the Hackfeld and Company.

The Court: In Hackfeld and Company?

The Witness: As I remember it. I was in the service at that time.

The Court: The Alien Enemy Custodian, when did he come in?

Mr. Wild: Well, it is stipulated, your Honor, that he seized the capital stock of H. Hackfeld and Company, Limited.

The Court: That's all he seized?

Mr. Wild: He seized the capital stock. The business kept on going. Then there was a change of officers, but the business of H. Hackfeld and Company was carried on as it was before.

The Court: Under Hackfeld management?

Mr. Wild: Under Hackfeld management.

The Court: Up until August 20, 1918?

Mr. Wild: That's right.

The Court: And on that date the Factors went in?

Mr. Wild: That's right. [145]

The Court: And on the 31st they made an evaluation of the property and securities which accounted for the setting up of this reserve account?

(Testimony of Sherwood M. Lowrey.)

That is, they found upon analysis that the value of the property was seven hundred and some odd thousand dollars more than they paid?

Mr. Wild: That's right, your Honor, that the net value—and that is shown in P-9—the net value of the assets exceeded all known liabilities by \$733,898.27 plus the \$11,525.18. Now, I want to be accurate on that. It has been my understanding—Mr. Cades says he doesn't think it is quite right.

Mr. Atherton: Your Honor, the previous witness so testified, that is, what the journal entries showed.

Mr. Wild: I believe it is right.

Mr. Cades: I don't think that is the testimony.

The Court: I've got a transcript journal here in evidence.

Mr. Atherton: If I remember correctly, the testimony of Mr. Eichelberger—

The Witness: Eichelberger.

Mr. Atherton: —due to the effect that this so-called reserve or difference, what is the difference between the book values and the capital stock and the book liabilities, as shown at the date the transfer was effected in 1918—

Mr. Wild: Well, that is right. Mr. Cades corrected me in one small item, that is, that the first page of P-9 [146] shows that as it was at December 31, '18, that the special reserve account of \$11,525.18 had come over from the old account, and that the new amount of \$733,898.27 is at the end of that year.

(Testimony of Sherwood M. Lowrey.)

Mr. Cades: Might I explain, your Honor?

The Court: So eleven thousand dollars or something before that——

Mr. Cades: The eleven thousand dollars was set up and represented the difference between the assets and liabilities and capital at January 1, 1918, which was the last balance sheet apparently of Hackfeld. On August 20th, when the transfer took place, there was an increase in the amount of assets not representing the revaluation but earnings presumably from the first of the year up until August 20th which were not known when the first entry had been made.

Mr. Wild: As I take it, the net result was that there were some seven hundred thirty dollars more in assets found at the end of the year.

Mr. Atherton: Seven hundred thirty thousand you mean?

Mr. Wild: Yes, seven hundred thirty thousand. And whether or not it is earnings or not, it is assets.

Mr. Atherton: I think Mr. Cades said it did represent the earnings from January 1st to August 30th. I think he testified a moment ago——

The Court: Well he wasn't testifying. He was giving [147] his version of where the account originated. But the ledger, the journal entry, if that is taken to be as fact, that explains where it arrived from.

Mr. Wild: Now, we have no further questions about these original records. If Government counsel



(Testimony of Sherwood M. Lowrey.)

wants to examine them further now, he may; if not, may we turn them over to Mr. Eichelberger?

Mr. Atherton: Are you through with Mr. Lowrey as a witness so I can proceed to cross-examine him?

Mr. Wild: No. I was just wondering if it was convenient for you to cross-examine him on these records so we can send them back. I have quite a number more questions to ask him but not about these accounts.

### Cross-Examination

By Mr. Atherton:

Q. Would you please look at P-7, Mr. Lowrey?

A. Which is P-7?

Q. It is that itemized list of litigation expenses.

Mr. Wild: That is in evidence. That is P-7.

Mr. Atherton: Yes.

Mr. Wild: But not for identification. It is in evidence.

Mr. Atherton: I am just identifying it.

Q. I wonder if you will tell the Court whether you have any knowledge about the character of the various expenditures itemized on this list?

A. I have, in a general way. I remember the——

Q. Now, then, would you follow through this list and notice down here on July 23rd there is a fee of one thousand dollars paid to Mr. C. R. Hemenway. Do you know whether or not there was any special arrangement as to when that fee was to be paid?

(Testimony of Sherwood M. Lowrey.)

A. We felt that Mr. Hemenway was being called away from his own business to take this particular task on. Mr. Hemenway was thoroughly familiar with every step that was taking place in connection with the organization, reorganization of Hackfeld and Company. And it was felt he would be entitled to additional compensation.

Q. Who was Mr. Hemenway?

A. Mr. Hemenway was a lawyer here who at this time, I think, had become assistant manager of Alexander and Baldwin.

Q. Was the amount of his fee fixed in advance or did it bear any relation to the outcome of the litigation?

A. That I cannot say. My recollection was, we felt, at least the steering committee felt that Mr. Hemenway should not be asked to go to the coast without proper compensation. And I think that the amount of compensation would depend upon the length of time this mission took him to the mainland.

Q. Now, following down that statement on July 31st, did you find an amount, fee paid, of one thousand dollars to Lucian H. Boggs? Who was Mr. Boggs?

A. Boggs, as I remember it, was an attorney in Washington, [149] D. C., and it was necessary that he be employed to gather certain information of the Alien Property Custodian's office.

Q. Was there any understanding, previous un-

(Testimony of Sherwood M. Lowrey.)

derstanding before the payment of the fee as to the amount what the services would be before he was engaged? A. None that I know of.

Q. Was there any understanding as to when the fee would be payable?

A. None that I know of.

Q. Now, you find further down on the statement of August 20th there is an amount of \$1,170.17 paid to Mr. Boggs, apparently for travel expenses. Oh, yes, it is a reimbursement, travel expenses, telephone, refunded to Mr. Boggs. Did he bill the American Factors for that or whom did he bill for that?

A. I do not remember whether Mr. Boggs was employed directly by the steering committee, who was in charge, or whether the attorneys in San Francisco who were hired in the case got Mr. Boggs to do certain things for them. And when the bill was submitted to us, it was paid.

Q. Well, do I understand from your testimony that you don't know whether Mr. Boggs represented American Factors or these other 23 co-defendants?

A. It was all so involved and mixed there together, that he was representing both parties. In other words, the [150] defense of the general suit.

Q. How about down here on the list, September 26, 1924, there is a payment of three thousand dollars, fees shown to have been paid to the law firm

(Testimony of Sherwood M. Lowrey.)

of Smith, Warren, Stanley and Vitousek; for what services was that fee paid and to whom?

A. It was paid to the law firm of Smith, Warren, Stanley and Vitousek for services in connection with this general matter. I presume that it was in connection with work they did relative to the duplicate suit that was filed in the Territory of Hawaii.

Q. Which suit?

A. The duplicate. It has already been discussed in the Court here to the fact that identical suits were filed in the Superior Court in San Francisco and in the Circuit Court of the Territory, but that the trial of the suit was going to take place in San Francisco. But it was necessary that certain steps be followed through in connection with the suit that was filed here in Honolulu.

Q. And would you say that this fee represented payment for services already rendered and completed by this law firm to the 23 co-defendants at that time?

A. I wouldn't say—it was probably on account. If I remember this, there were further fees paid to them as the case went along. The thing was not settled at that time [151] by any means, and I presume this was a payment on account.

Q. On October 25, 1924, the statement shows fees totaling two thousand dollars paid to Pillsbury, Madison and Sutro. Was that for services already

(Testimony of Sherwood M. Lowrey.)

rendered in accordance with the bills rendered by that law firm?

A. It was a payment made to them on account of services rendered.

Q. Was there any understanding with that law firm, to your knowledge, that their fees would be contingent upon the outcome of the litigation or on the part of the merit basis as they were rendered from time to time?

Mr. Wild: I object to that. It calls for the conclusion of the witness, on what merit is. Even courts disagree on that.

Mr. Atherton: I think I will rephrase it to avoid the objection.

The Court: I think it can be explained in connection in which it is used here. Do you understand it?

The Witness: My answer is, I don't know. I didn't make these arrangements with Mr. Sutro.

Mr. Atherton: Very well.

Q. The statement shows as of November 29th a fee of two thousand dollars paid to Eberhard Haynes. Who was Mr. Haynes?

A. Mr. Haynes was another attorney in the City of [152] Washington who had rendered services in connection with this whole matter.

Q. Do you have any knowledge as to what his arrangements were with respect to fees and services?

A. I do not believe there's any arrangement. He was called upon to render service from time to



(Testimony of Sherwood M. Lowrey.)

time, as it indicated, and it is my recollection that when his bills came in they were paid like any other bills in connection with this whole matter.

Q. Very well. Now, on December 16th, the statement shows fees to the, fees totaling fifty thousand dollars, paid to Oscar Sutro. What is your recollection about the arrangement respecting those fees?

A. The arrangement with regard to Mr. Sutro was fixed up by the steering committee. When his bill came in for fifty thousand dollars it was considered and ordered, and I was told to pay it.

Q. Now, that statement also show as of December 16th——

The Court: What year?

Mr. Atherton: 1924, your Honor.

A. Page 2?

Q. That is on page 2 of the statement. It shows the amount of eight thousand dollars recorded as final payment of fees to Lucian H. Boggs. Do you have any further explanation of that? [153]

A. No, sir. All I can make is the presumption.

Q. Now, on December 16, 1924, the statement shows the amount of \$7,113.25 fees and expenses paid to Smith, Warren, Stanley and Vitousek. Do you have any further explanation of that item?

A. Merely that these attorneys here were gathering information, one thing and another, following the case here, reporting presumably to Mr. Sutro, and it was in connection with the general expenses of the case.

(Testimony of Sherwood M. Lowrey.)

Q. For services rendered to date?

A. I wouldn't say that. I don't know.

Q. The statement shows as of December 27, 1924, the sum of five thousand dollars cash advanced to W. H. Lawrence of Pillsbury, Madison and Sutro. Will you explain to the Court what that advance was on account of?

A. W. H. Lawrence was an attorney in San Francisco, and he had been brought into the case by Mr. Sutro. This says fees, cash advanced to Lawrence. It may be a poor explanation but I should say it was a payment on account of fees for services rendered by Mr. Lawrence.

Q. A statement on page 3 as of February 19, 1925, shows the sum of \$2,266.67 paid to Pillsbury, Madison and Sutro as expenses for their December, January disbursements. Will you explain to the Court, please, more in detail what that means?

A. A detail with expenses I cannot give. I can make a presumption that there were a great many cable costs going through; possibly it could have been cable messages; it could have been some traveling expense; it could have been any number of items that they had taken and made an outlay and they are entitled to reimbursement.

Q. Very well. Now, the statement shows on page 4 as of February 28, 1925, the sum of \$46 sundries for binding 24 volumes of the Star-Bulletin, freight to San Francisco. Explain why that was regarded as a part of the litigation expense?

(Testimony of Sherwood M. Lowrey.)

A. None other than it was something other—the expense was incurred in connection with the case. In other words, the general principle followed through that if money was laid out in connection with the defense of this case, such amounts were charged up to this account.

Q. On March 12, 1925, the statement also shows disbursement of \$5.60 for newspapers to Sutro. Would your answer with respect to the explanation of that entry be the same as it was with respect to the \$46 item?

A. As I recollect, there was a lot in the newspaper about this case here. If you want to use this term, a hot subject was going on. There was a great deal of feeling in the community about it. Without question the newspapers had some articles in there that it was thought advisable [155] to pass on to Mr. Sutro. For some reason they were acquired and sent on.

Q. Now, the statement shows as of March 21, 1925, the sum of \$138.82, sundries, Yosemite Taxicab Company. Can you explain to the Court the particular relation of that expenditure to the conduct of the litigation?

A. I can again make a surmise, if you wish me to.

Q. No. If you don't know, just say you don't know.

A. I can say this, that there were many men from here who were in San Francisco testifying in

(Testimony of Sherwood M. Lowrey.)

the case. The court building was a considerable distance away from the hotel, and it was necessary to use taxi cabs.

The Court: Let us recess this case for a few minutes.

(A short recess was taken.)

After Recess

By Mr. Atherton:

Q. Now, Mr. Lowrey, we might save the Court time. If you will look at that Exhibit P-7, beginning at page 4, down to the end, particularly with respect to the fees paid to the various parties mentioned therein, state to the Court whether or not the testimony that you have hereofore given with respect to the other fees would be the same with respect to these, if I were to question you specifically with respect to each item?

A. I think it would be, namely, to the effect that [156] as services were rendered payments were naturally made for account of services as they went along. And in connection with these expenses here, it is very difficult at this stage to remember back which each one was, but at the time the expenses were incurred and authorized to be paid, they were analyzed carefully at that time and when payment was made they were considered as a proper litigation expense. It was charged to this account.

Q. Now, specifically, would you please look at page 9 of this exhibit as of January 19, 1926. You

(Testimony of Sherwood M. Lowrey.)

will note that the statement shows the amount of \$100,000 representing the balance of the fee paid to Oscar Sutro.

A. I notice that.

Q. What would be your statement by way of explanation of that?

A. I have none to make other than what it says right here on the face of it. That was a matter that was handled entirely, an amount like that, handled by the steering committee, and they apparently authorized it to be paid, and it was so paid.

Q. Now, if you will look at that same statement on that same page, as of March 23, 1926, it shows an additional sum of \$50,000 paid to Oscar Sutro. Can you reconcile the two statements appearing thereon with the previous one, that \$100,000 that represented the balance of the fee payable to [157] Oscar Sutro, and yet there was additionally paid to him the sum of \$50,000 at a later date?

A. As a recollection, the balance of the fee, the January 19th item might have been the balance of the fee, in connection with the case before the Superior Court. Then, as the testimony has already showed, there were appeals made and further work was done in the case, as more services were rendered.

Q. In other words, you would say, then, that the \$100,000 fee was paid, the balance of the fee



(Testimony of Sherwood M. Lowrey.)

paid to Mr. Sutro for services rendered in the lower courts?

A. I say that is a possibility, because I was merely the accountant, so to speak, when those big matters came up. It was passed by this group, and I was told to pay the money.

Q. Now, over on page 11 of the statement, as of July 28, 1932, there appears thereon the sum of \$85,000 paid to Mr. Oscar Sutro, stated to represent the final fee including that due associates. Do you know whether or not that fee included services rendered by Mr. Sutro and his associates during the calendar year 1930 and 1931?

A. I do not know that specifically.

Q. What other explanation can you give the Court with respect to that payment?

A. Well, the hundred thousand dollar fee that you mentioned I think was in 1926, was it not? Yes, in 1926. Then [158] the fifty thousand came in March 23, '26. As the record shows, the case was not finally determined until 1932. And as these various steps were taken in the case, it took legal service in connection therewith. And hence a 6-year period elapsed there. I presume this was the balance of the fee for those services.

Q. After the conclusion of the proceedings in the lower court, is that correct?

A. Yes, but of course the decision in the lower court was appealed and it was necessary to follow the case through to its ultimate conclusion.

(Testimony of Sherwood M. Lowrey.)

Mr. Atherton: I think that is all the examination that I care to make with respect to this particular exhibit.

The Court: I am curious to know——

Mr. Wild: I'd like you to ask the witness any question you want, your Honor.

The Court: Well, I am curious to know why they paid Atherton Richards thousands of dollars, seven thousand at one time, and then lesser sums at different times?

The Witness: Atherton Richards was not a member of a law firm. His name was given——

Mr. Wild: Not a law firm?

The Witness: Not a law firm; an engineering and consultant and appraising firm. I forget the name of the concern. It was at Mr. Richard Cooke's request that he was [159] brought in to try and establish the value of certain of the plantation holdings. I recollect a question in the case had to do with value in that the complainant had charged they received ten million dollars less than what was the proper value. And it was necessary to get some outside talent in there, impartial witnesses, who could take and make an analysis of how certain plantation earnings, and so forth, were in order that they could arrive at what would be considered a fair value of the plantation stocks which Hackfeld and Company owned.

The Court: Well, he was one of the subscribers, wasn't he?

(Testimony of Sherwood M. Lowrey.)

The Witness: Atherton Richards, no, sir. At least I do not think so.

The Court: Frank Atherton, money, different times, \$500. You don't know about that?

The Witness: A large number of these men had to go up to San Francisco in order to be witnesses in the case in San Francisco, and it was felt it was proper to take and pay them an amount to cover their travel expenses and hotel bills while in San Francisco.

The Court: Why did they pay the Alien Enemy Custodian here, Richard Trent, \$5,000 and various other sums, do you know?

The Witness: If I remember correctly, Mr. Trent went [160] up and was a witness on the stand there for many, many weeks. And these expenses of living up there were all coming against him as an individual.

The Court: Well, it was 'way in '26 in March that he was paid \$5,000. Would that apply to Walter Dillingham who received a thousand dollars in one payment?

The Witness: I think so. It was a procedure that was used with all of these witnesses. And there were a great many of them that were called to the coast. While this was going on it was necessary to take and have these men go up, and after point after point was brought up there by the complainant up there, it was necessary to send down here to get witnesses to go up and refute those

(Testimony of Sherwood M. Lowrey.)

things and also to take and gather information here which the firm of Smith, Warren, Stanley and Vitousek did of gathering data to send up for the use of counsel who was appearing for the group.

The Court: Well, Trent was named as a defendant? All right.

Mr. Wild: Any other questions your Honor wants to ask?

The Court: No.

Direct Examination

(Continued)

By Mr. Wild:

Q. Mr. Lowrey, at the time these amounts were paid, who directed the payment of them?

A. The payment that is made on account of these expenses? [161]

Q. That's right.

A. The ordinary, customary and regular ones I directed the payment of them. The bigger ones, why, these larger fees and the payments of the individuals concerned for travel expenses, it passed the group, the steering committee.

Q. What do you mean it passed them?

A. Well, they passed on it and told me to pay it.

Q. I see. And at the time when—I take it this is the substance of your testimony—at the time when that was fresh in your recollection as it occurred, you knew of your own knowledge about the

(Testimony of Sherwood M. Lowrey.)

minor expenses and what they were for and passed them?      A. Yes.

Q. Under general direction from the committee, the so-called steering committee, is that correct?

A. That's correct.

Q. And the larger items were all passed on by the steering committee, and you were told to pay them?      A. That's correct.

Q. Now, Mr. Lowrey, are the members of that steering committee now living or dead?

A. All dead.

Q. And the last survivor, Mr. Charles R. Hemenway, just recently died?      A. Yes. [162]

Q. I think you said the local firm of Smith, Warren, Stanley and Vitousek were employed in connection with the San Francisco litigation.

A. They were.

Q. And what were the duties in regard to that, if you know?

A. Well, following the suit that was filed——

Mr. Atherton: Your Honor, I think that the witness is not qualified to answer that question. I think the members of that law firm would be the only parties who can properly answer that question.

Mr. Wild: He can say. He knows as a businessman that this firm furnished services by investigating evidence here. That is part of his job. He knew it. I don't think you need an attorney at law, a member of the firm to testify to that. And



(Testimony of Sherwood M. Lowrey.)

I am merely referred to things brought out in cross-examination on the point. That is all.

The Court: Well, I took the point of the cross-examination to be more as to the time when the payments were made, and if that settled the business up until that time, not an inquiry as to what the services were. And I don't know—so long as they were engaged and paid for for legal services, I don't see where the Court can be concerned with that.

Mr. Wild: I don't either, your Honor. And that is why I was clearing it up. [163]

Now, may I return to direct examination and ask that the Court permit me to withdraw the original exhibits and turn them over to the custody of Mr. Eichelberger?

The Court: Well, yes. They haven't been made exhibits?

Mr. Wild: No.

The Court: They were here for examination?

Mr. Wild: Examination, your Honor. Mr. Eichelberger, if you will take them, and then I'd like to resume my examination of Mr. Lowrey.

Q. (By Mr. Wild): Mr. Lowrey, you were treasurer of American Factors in the years '31 and '32, as you have already testified? A. I was.

Q. During the latter part of the year '31 or the early part of the year '32, calling your attention to that time, was there any discussion with Mr. Bottomley concerning the Hackfeld litigation expenses?

(Testimony of Sherwood M. Lowrey.)

A. There was.

Q. And can you place about the time of that discussion which you had?

A. I'd say it would be the early part of the year, that is, '32.

Q. '32? A. Early part of '32.

Q. Can you remember any more definitely? Was it after [164] the final decision in the Supreme Court of California?

A. Yes, it was after that.

Q. After that?

Mr. Atherton: Your Honor please, I object to counsel leading the witness.

Mr. Wild: Well, I was just trying to fix a time.

The Court: Yes. The matter of memory, recollection of a date as old as that, I see no evil in it. You can't fix the date?

The Witness: Not the exact day the conversation took place. To say January or Februry of '32, no, sir, I cannot.

Q. Was it before or after the report had been received or the decision of the Supreme Court of California in the Hackfeld litigation?

A. Afterwards, as I recollect.

Q. And where was that conversation?

A. Either in Mr. Bottomley's office or my own. The two offices were adjoining. Sometimes he would call me in there; sometimes he would come out and talk to me in my own office.

(Testimony of Sherwood M. Lowrey.)

Q. And that was in the old Hackfeld building, now the American Factors building?

A. That is correct.

Q. Down on Fort and Queen Street?

A. Yes, sir. [165]

Q. Honolulu? And was there any discussion concerning the Hackfeld litigation expenses at that time?

A. Yes. The decision had been rendered in the Superior Court, with which this Court is now familiar. There had been the appeal to the Supreme Court of the State of California. It had been successful there. It was then some other legal step in connection with the Remitter—is it not?

The Court: Yes.

A. I think that is the legal term, the details of which I am not conversant with. They were successful in that. Then there was a further step, as I remember it, in connection with the Supreme Court of the State of California, successful there. And at that time it was felt that the case was——

Mr. Atherton: Excuse me, your Honor. He is purporting to say what was felt.

Mr. Wild: No, what was said.

The Witness: I was going to say that I felt and others agreed with me to the effect that our effort had been successful, that the case was practically closed. There was only one further step that could have been taken, and that was to have it reviewed by the United States Supreme Court, which was

(Testimony of Sherwood M. Lowrey.)

later attempted and which was denied. In connection with the expenses, in view of the fact that the whole formation of this company was involved, every stockholder was involved, [166] it seemed right in my opinion, and in the opinion of others, that the expense of all this litigation should become a company expense rather than to have the burden of something in excess of half a million dollars thrown on the shoulders of a group, with which the court is familiar, and make them bear it; where it had been their efforts in creating American Factors, their efforts had been successful in creating and bringing into being this organization which was to be a benefit to the community and to the other 600 odd shareholders.

The Court: Well, I think that you rather are taking advantage of your opportunity to answer the question by making a speech telling what your personal views were. I think you have gone 'way beyond the answer to the question.

Mr. Atherton: Your Honor anticipated my objection. I was going to move here that we strike Mr. Lowrey's testimony as not being responsive to the question and as extending far beyond what would be necessary and responsive in reply.

Mr. Wild: I have called attention to the Court before that there isn't any such objection——

The Court: We won't strike it. Go ahead with your examination.

Q. (By Mr. Wild): Mr. Lowrey, what, if any,

(Testimony of Sherwood M. Lowrey.)

statements did Mr. Bottomley make to you concerning these litigation expenses and his investigations concerning them? [167]

A. He told me that he had conferred with Mr. Oscar Sutro, who had been chief counsel for the defendant, and that he, Mr. Sutro, had advised Mr. Bottomley that in the opinion of Mr. Sutro the expenses incurred——

Mr. Atherton: Your Honor, I object to that as hearsay.

The Court: Well, that is hearsay all right.

Mr. Wild: Your Honor, the subject matter here is to prove the fact of an opinion given in an official course of conduct of American Factors' business from the president of the company to the treasurer of the company, for the information of an officer of the company in this matter at a time when there was no thought of any Federal income tax question or any other thing involved in it, your Honor. And I take it——

The Court: I know, but for the witness to undertake to tell what motives Mr. Bottomley was acting upon due to something that someone had told Mr. Bottomley, it is rather going too far. It is in the field of hearsay.

Mr. Wild: Well, your Honor, what I have asked him about, if there was an opinion given of counsel at that time.

The Court: Well, does the witness know?

The Witness: Yes, there was.



(Testimony of Sherwood M. Lowrey.)

Q. Do you know whether or not there was an opinion of counsel, Mr. Sutro, given at that time?

A. There was. [168]

The Court: A written opinion?

The Witness: That I do not know, Judge.

The Court: Well, how do you know there was an opinion?

The Witness: Because I was so told by Mr. Bottomley.

The Court: Well, that is the basis, then, for your belief that there was an opinion given?

The Witness: Yes, sir.

Q. And what was that opinion?

A. The opinion was——

Mr. Atherton: That, your Honor, I object to. The best evidence of that opinion is either the written opinion itself or Mr. Sutro.

Mr. Wild: Well, your Honor—is Mr. Sutro living or dead?

The Witness: He is dead. He died many years ago.

Mr. Wild: I know that of my own knowledge.

Mr. Atherton: Well, some member of his firm, certainly not the witness. The opinion wasn't given to him.

Mr. Wild: He has a report of an opinion that is given by the president of the company to the treasurer, and the treasurer with knowledge of that opinion acts on it in part. This isn't a case——

The Court: I don't follow you there that the

(Testimony of Sherwood M. Lowrey.)

treasurer acted on some opinion that Mr. Bottomley said was given to him. I understood the witness to say that from time to time he acted upon directions, instructions, except as to certain [169] smaller matters of finance that were left to his own discretion. But upon the larger matters, matters of policy, that he received directions. He testified that Mr. Bottomley investigated, told him what to do, to be sure. But as to the motives that impelled Mr. Bottomley to tell him what to do or advise him, I think it is too far.

Mr. Wild: Very well. May we have an exception to your Honor's ruling?

The Court: Yes.

Mr. Wild: And in that connection may I make an offer of proof, your Honor? I will prove that Oscar Sutro——

The Court: Yes.

Mr. Wild: ——the head counsel for the group of defendants in the cause, gave an oral opinion to Mr. Bottomley, now deceased, or partially in writing, now lost, to the effect that in Mr. Sutro's opinion as a lawyer the total expense of the Hackfeld litigation was a legal liability of American Factors, determined as such at the conclusion of the litigation.

The Court: Do you want to follow that?

Mr. Atherton: I want to remark that his offer of proof should be confined to the fact that Mr. Sutro gave an oral opinion, expressed an oral opin-

(Testimony of Sherwood M. Lowrey.)

ion to Mr. Bottomley, and not what the text of that opinion was.

Mr. Wild: Well, I can show what the opinion was, too, [170] if I want to.

Mr. Atherton: I don't believe he may do that, your Honor.

Mr. Wild: Of course I can.

Mr. Atherton: It would be objected to on the basis of hearsay.

Mr. Wild: This has nothing to do with hearsay. This is part of the *Res gestae* of the whole situation, your Honor, as I see it.

The Court: Well, do you want to put him to the proof, then? He made an offer of proof.

Mr. Atherton: Yes, I want him to prove the opinion by Mr. Sutro.

Mr. Wild: But Mr. Sutro is dead.

Mr. Atherton: He can do it by any competent witness.

The Court: Well, let him go forward with his proof, then.

Mr. Wild: Well, your Honor, I said I'd offer to prove it by this witness, that that was a report made by Mr. Bottomley.

The Court: I didn't understand you to say that this witness would prove the report made by Mr. Bottomley in your offer to prove.

Mr. Wild: Well, let me make it clear, then, your Honor. I offer to prove that this witness will testify that Mr. [171] Bottomley informed him that

(Testimony of Sherwood M. Lowrey.)

Mr. Oscar Sutro, the head counsel for the company, had made the statement concerning the opinion about which I have just stated, and that Mr. Oscar Sutro is now dead. I think that is in evidence. And that is part of the *Res Gestae* and we offer it as such.

Mr. Atherton: My objection, your Honor, is the same as it was when the witness undertook to testify, that he is not qualified to testify; it is hearsay testimony. The best evidence of the opinion expressed by counsel is either counsel's statement as to that opinion or the written opinion or a copy thereof, if the original cannot be accounted for.

Mr. Wild: Well, all opinions aren't written, your Honor. I give many opinions. I gave one this morning in a very complicated matter. And, as your Honor well knows, there are many of them that are oral opinions, and when they are so given in the course of conduct of a matter they form part of the *Res gestae* and they are not hearsay so far as the Government is concerned in any tax case. They are not hearsay at all. They are just part of the *Res gestae*.

The Court: Well, perhaps it wouldn't be hearsay coming from Bottomley, but coming from someone whom Bottomley quoted as being the statement of someone else, I can't help but believe that it does come within the hearsay rule.

Mr. Wild: Well, does your Honor so rule?

The Court: Yes. [172]

(Testimony of Sherwood M. Lowrey.)

Mr. Wild: And we may have our exception to that ruling?

The Court: Yes.

Mr. Wild: I want to make clear the grounds of what my exception is, that the statement by the president of the company to the treasurer of the company made after the decision of the Supreme Court of the State of California had become final, was a part of the *Res gestae* and as such not hearsay. It is part of the *Res gestae* in this whole matter, what they were doing and what they were discussing, and what they were acting on at that time.

The Court: The exception is noted. Go ahead.

Q. (By Mr. Wild): I will show you, Mr. Lowrey, what purports to be a copy of an opinion from the firm of Smith, Wild and Beebe, dated March 3, 1932. I will ask you if you examined that?

A. I have.

Q. And to the best of your knowledge is that a copy of an opinion which was furnished to American Factors, Limited?      A. It is.

Mr. Wild: I have already furnished counsel with a copy of the letter.

Mr. Atherton: What is the date of the opinion?

Mr. Wild: March 3, 1932. I note that this copy is not signed. I think it was signed, it was made from a copy in our files, which was not signed, your Honor, and I think the [173] Government has a signed copy of it.



(Testimony of Sherwood M. Lowrey.)

Mr. Atherton: Wait a minute. I want to get the signed copy in.

Mr. Wild: I think it is signed by Arthur G. Smith. It is just as much hearsay in this as the other, but I don't care. The Government wants it in. Maybe we made too much about Sutro's opinion, your Honor. It is in the contemporaneous corporate records, to wit, the minutes of the stockholders' meeting, and it is reported and it is annexed to our exhibit. But I was asking this witness about it because he had knowledge of his own. May the record show that this was signed. That is wrong; it is Arthur G. Smith; he never had an initial "T". This letter was signed "Smith, Wild, Beebe and Cades by Arthur G. Smith." But the form which I have here is in blank, your Honor, because we didn't have a signed copy in the office. Except for that, that is a copy of the letter.

The Court: Did the witness see the original?

The Witness: Yes.

The Court: When?

The Witness: Shortly after it was received. Bottomley passed it out to me to read.

Mr. Wild: And we'd offer this letter in evidence, asking that it be marked by the clerk in the blank space as Arthur G. Smith. [174]

Mr. Atherton: No objection.

Mr. Wild: The Government has no objection because they asked that I put this in.

(Testimony of Sherwood M. Lowrey.)

The Court: That is exhibit—you want to follow these P's?

Mr. Wild: Yes, for the plaintiff; P-10.

The Court: That would be P-10, then. Letter of, what date?

Mr. Wild: March 3, 1932.

(The document referred to was received in evidence as Plaintiff's Exhibit P-10.)

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PLAINTIFF'S EXHIBIT P-10

March 3, 1932

American Factors, Limited,  
Honolulu, T. H.

Attention: Mr. A. W. T. Bottomley,  
President.

Gentlemen:

You have asked for our opinion on two questions: (1) whether reimbursement by American Factors, Limited, of the individual respondents in the various suits entitled "J. C. Isenberg, et al, Complainants, vs. George Sherman, et al, Respondents", is within the corporate powers of your corporation; and (2) whether if question (1) is answered in the affirmative your corporation is under a moral obligation to make such reimbursement.

You are hereby advised that in our opinion under the facts as hereinafter stated, both questions should be answered in the affirmative.

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-10—(Continued)

In order that your stockholders, officers and directors may be advised as to the reasons for this opinion, we deem it advisable to incorporate herein a brief summary of the important events out of which the litigation arose.

H. Hackfeld & Company, Limited, an Hawaiian corporation, was during the World War and prior to 1918, apparently because of the nationality of certain of its directors, officers and stockholders, blacklisted by the British authorities and under suspicion by the United States authorities, and its cable communications and also its importation of certain supplies necessary in its business had been stopped. Apparently all of the shares of stock, except 1400 shares which had been sold to certain Americans in 1916, was held by Germans or by American citizens of German birth or parentage.

The actual management of the company's affairs was in the hands of Messrs. Rodiek, Hagens and Humburg. Mr. Hagens was acting manager at Honolulu, while the other two were in San Francisco. The Trading with the Enemy Act had been passed in October, 1917, and Mr. Hagens had apparently become very much discouraged over the future of the company, and after taking the matter up with the two above-named who were in San Francisco, it was decided that the only thing to do was to "Americanize" the corporation, and that if this were not done the corporation would go to pieces.

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-10—(Continued)

A scheme of reorganization was worked out by the three and the other directors of Hackfeld & Company, under which a majority of the stock would be turned over to American citizens not under suspicion. The matter was taken up with the Alien Property Custodian, but was not satisfactory to him for reasons which need not be detailed herein, except to state that he considered it contrary to the procedure required by him under the Trading with the Enemy Act, and that he believed he should effect his own reorganization.

Accordingly the scheme devised by Mr. Hagans et al was unscrambled, the stock which had been transferred to American citizens under that scheme was turned back, and the Custodian started to effect his own reorganization.

During the course of the proceedings, three plans were outlined as a possible solution: (1) A sale of the enemy-owned stock of the company in somewhat the same manner as had been suggested by Hagens, et al; (2) The disincorporation and the sale of the company's assets by piecemeal; (3) The sale by the corporation of its entire property and business as a going concern to a new corporation to be organized under the laws of Hawaii for that purpose. Incidentally, it might be stated that when Messrs. Hagens and Humburg went to Washington, together with Judge Frear, to attempt to secure the consent of the Custodian to their first scheme, both Hagens

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-10—(Continued)

and Humburg, according to the decision of Judge Murasky, repeatedly stated that \$180. a share would be a fair price for the Hackfeld stock.

It should also be noted that if the corporation's assets were sold piecemeal this procedure would have benefited primarily existing sugar agencies, since they would naturally have succeeded to the agencies of the various corporations represented by Hackfeld & Company.

The Custodian insisted upon the third possible plan, to-wit, the organization of a new corporation. He set a figure of \$7,500,000., or \$300,000. more than the value which Hagens had fixed on the 40,000 shares of Hackfeld stock, disregarding the admitted lower value of the 3,000 shares of preferred stock constituting a part of the 40,000 shares.

The organization was carried through according to his views and resulted in a price to the Hackfeld stockholders of approximately \$194. a share instead of \$180. a share.

American Factors was incorporated for \$5,000,000., with 50,000 shares of the par value of \$100., and pursuant to the plan of the Custodian, this stock was offered at \$150. a share, resulting in a total of \$7,500,000., the price fixed by the Custodian as the value of Hackfeld & Company's assets, and the payment of \$194. a share to the Hackfeld stockholders, although J. F. Hackfeld, Limited, had in January, 1918, sold 11,000 shares of its stock in H. Hackfeld



(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-10—(Continued)

& Company, Limited, for \$180. a share. J. F. Hackfeld, Limited, was an Hawaiian corporation, nearly all of the stock of which was owned in Germany, and which owned 12,647 shares of stock in H. Hackfeld & Company, Limited.

The Alien Property Custodian had, under his authority, seized all of the Hackfeld Company stock owned by alien enemies, and this stock was voted under the reorganization pursuant to his instructions.

In July, 1918, a special meeting of the stockholders of H. Hackfeld & Company, Limited, was called to vote upon the question of the transfer of the assets of that company to American Factors, Limited. At this meeting every share of stock in the corporation, except 160 shares held by one stockholder who later ratified the proceedings, was voted in favor of the reorganization and in favor of the sale to American Factors, Limited, for approximately \$7,500,000.

Certain of the respondents in the Isenberg suit were named as trustees to handle the financial end of the reorganization. The details of their operations, which were pursuant to instructions from the Alien Property Custodian, need not be detailed here, except to state that twenty-three of the respondents submitted a joint subscription for a total of 27,000 shares of the 50,000 shares of American Factors, Limited. According to the Supreme Court

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-10—(Continued)

in California, the purpose of this group subscription was eminently proper inasmuch as if they were to invest approximately \$4,000,000. in the new enterprise they were entitled "to be sure that at least half of the stock of the new company should be held by those who would bring skill and experience in the sugar business to the new corporation".

The first Bill in Equity was brought in December, 1924, and substantially identical actions were filed both in Hawaii and in California.

The Complaint alleged that the assets of Hackfeld & Company were worth approximately \$17,500,000. and that the sale to American Factors, Limited, resulted in a loss to the Hackfeld & Company stockholders of approximately \$10,000,000., that the entire proceedings were the result of a conspiracy on the part of all the respondents, including American Factors, Limited, and that American Factors, Limited, after taking over the assets so mismanaged the business as to cause a further loss of approximately \$2,500,000.

The Complaint alleged that American Factors, Limited, took over the assets with full knowledge of the conspiracy and with full knowledge of the equities of the stockholders of Hackfeld & Company, and that with such knowledge, had mismanaged the assets so as to cause the above damage to the old stockholders. It was further charged that American Factors, Limited, with full knowledge of the rights

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-10—(Continued)

and equities of the complainants on or after July 11, 1924, made transfers on its stockbooks to the purchasers of the stock, as a part and in consummation of the general fraudulent scheme, although notified by the complainants of their objection thereto and of their alleged rights and equities.

The Complaint prayed for accountings from the various respondents and full disclosure of their respective acts, including the acts of those respondents who served as trustees, and prayed for an order and judgment of the court that the officers and directors of American Factors, Limited, make an accounting of their doings as such officers and directors, that American Factors, Limited, be directed to hold that portion of the assets and business which it had received from Hackfeld & Company in trust for the complainants, and subject to the satisfaction of any judgment that might be entered; that judgment be entered against American Factors, Limited, together with other respondents in favor of the complainants in such sum as the court might find the complainants entitled to; and also that judgment be entered against American Factors, Limited, specifically for such amount as the court might find the respondents had been injured by the mismanagement and breach of fiduciary duty committed by American Factors, Limited. This Complaint apparently did not seek to have the reorganization set

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-10—(Continued)

aside. It was instead an attempt to secure a money judgment, but we are informed that recently all or certain of the complainants brought suit in the State of New York, one of the purposes of which was to secure a rescission of the entire transaction.

In June, 1924, upon information reaching the directors that a suit was contemplated, your president was authorized and instructed by the Board of Directors to take the necessary steps to secure counsel to handle the case for the corporation, and the services of Mr. Oscar Sutro were definitely secured shortly thereafter, and other attorneys were subsequently engaged to assist him.

These attorneys prepared a joint answer on behalf of all the respondents, including your corporation, and this answer was signed by the attorneys as counsel for all the respondents and was sworn to by two individual respondents, the oath of all respondents in a case of this kind being unnecessary.

From the foregoing it appears that your corporation was vitally interested in the outcome of the litigation in all of the suits which had been brought by the complainants, and also that the acts of the respondents upon which the suits were predicated were intended to be and were for the benefit of the corporation, and while we do not consider it necessary at this time to go into a discussion of the authorities, as we stated at the outset of this opinion it is our view that any such reimbursement is within

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-10—(Continued)

the powers of the corporation; in other words, such payments would not be ultra vires; and that your corporation is under moral obligation to make such reimbursement upon proper authorization of the stockholders.

Very truly yours,

SMITH, WILD & BEEBE,

By /s/ ARTHUR G. SMITH.

AGS:F

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The Court: Do you want to adjourn now?

Mr. Wild: If it would meet your Honor's pleasure. I think I will close with my opening of Mr. Lowrey on this issue.

The Court: Now let's sort of take stock about how far we are along here. This is a day and one-half. Are we halfway through?

Mr. Wild: From my angle, your Honor, I have practically completed the Hackfeld litigation. The pension fund wouldn't take us 10 minutes I don't think. The Henry Waterhouse Trust Company matter I think I could finish with my witnesses in one day. And I don't know whether the Government has any or not.

Mr. Atherton: Your Honor, I would like to cross-examine Mr. Lowrey after lunch, and I don't think it will take more [175] than an hour at the most to complete that. And then I would say that unless



(Testimony of Sherwood M. Lowrey.)

Mr. Wild wishes to further examine him that that would probably close the Hackfeld issue. As far as the Waterhouse note issue is concerned, I doubt if the Government has any particular witness to put on the stand.

The Court: Well, now, the plaintiff will probably finish its case by noon tomorrow, is that right?

Mr. Wild: I would think so.

The Court: Well, then, the Government will take about how long?

Mr. Atherton: The facts on the Waterhouse issue have been substantially stipulated to, so that unless they are going to be supplemented by some testimony that plaintiff will put in——

The Court: Then as to argument.

Mr. Atherton: Well, I will make the Government's argument at the conclusion of Mr. Wild's argument, and I think if he can tell the Court about how long he will take, why, I can probably approximate how long I will take.

The Court: All right, Mr. Wild, how long do you think you will take in the argument?

Mr. Wild: I think if your Honor could allot me an hour and one-half for opening and closing, or an hour——

The Court: Yes, I can do that.

Mr. Wild: You see, I have the privilege of opening and [176] closing, as I see it. And I am in the dark as to what counsel's position is. I have already given him my brief, a preliminary one, so

(Testimony of Sherwood M. Lowrey.)

that he knows some of the cases that I have in mind to present.

The Court: That is this preliminary statement that you gave to me yesterday?

Mr. Wild: Yes, your Honor. There are also some technical questions in there which I haven't yet called to your Honor's attention other than the memorandum on the pleadings, for instance. The Government failed to answer the allegations in a number of paragraphs in our pleadings. Under the rule applicable that is an admission of all such allegations, in those particular paragraphs which were not denied or otherwise pleaded to; there was reference made in two of them to Exhibit A which set forth the facts in our claims. And those were not denied. And under the rule, Rule 10(c), they are part of the pleading. And if not otherwise denied, they are all admitted.

The Court: The new standard rules for District Courts, were they in force at the time the answer was made?

Mr. Wild: They were in force at the time before the complaint was filed, your Honor, because I had to look up and get my complaint within the rules. It was new pleading to me, your Honor, and therefore I have a skeleton of the whole thing. So that these technical questions of pleading I don't [177] want to press further than just to raise the issues, because they do raise some serious issues.

(Testimony of Sherwood M. Lowrey.)

The Court: I noticed that you mentioned that in this memorandum.

Mr. Atherton: Since counsel has mentioned that, your Honor, I want the record to show that I didn't prepare the answer to the complaint herein.

Mr. Wild: I know you didn't.

Mr. Atherton: But under the rules I intend to move to conform the Government's answer with the proof, and now I'd like the record to show that the Government would like to amend its answer to deny all the allegations contained in the claims for refund.

Mr. Wild: May it please the Court, we allege that once having admitted them under the rule of court that if that rule means anything the Government is bound by it just the same as I would be as an individual. It is too late now, may it please the Court.

Mr. Atherton: I'm sorry, your Honor, under the rules each party has an opportunity once as a matter of course to amend his pleading. And certainly the Government isn't going to be bound by the mistake, if it was a mistake, of some attorney in the department, and I don't admit that he did so, but if he did so overlook the way the complaint incorporated by reference, as it did, the claim for refund, certainly there [178] was no intent on the part of the Government attorney to admit any allegation contained in the claim for refund.

The Court: I don't see how Mr. Stainback, who was named in the answer, I don't see how he could

(Testimony of Sherwood M. Lowrey.)

represent the Government in this matter because it appeared to me from this exhibit here that he was employed and paid a fee in this litigation.

Mr. Wild: May it please the Court, it is nevertheless the answer of the Government. I don't care whether the Governor should refund something or not. Under the rules of court, if they mean anything, the defendant's motion comes too late by five years, approximately five years and nine months. Had there been a timely motion made immediately after answer filed, your Honor, we might have listened to it.

The Court: On April 29, 1925, is an entry, "Fees, I. M. Stainback, \$1,000." The same date, "Expenses, I. M. Stainback, \$245." I notice that Mr. Stainback, while he was U. S. Attorney here, made and filed the answer in the case.

Mr. Wild: May it please the Court, under the rule the pleading goes back to Washington, as your Honor well knows, where a collector, other official of the Government, is concerned, or other official is concerned. Also, as counsel for the Government has now stated for the defendant here, those answers are prepared in Washington and sent forward for filing here. The present counsel is representing the [179] Government in Washington. He is in no wise responsible for this matter. I know that. But it doesn't make any difference about these payments. That is the answer of the defendant in the case, and under the rule it is binding upon all parties in conformity

(Testimony of Sherwood M. Lowrey.)

with the rules. Now, if the Government had wanted to make a timely motion some five years and nine months ago, there might have been some merit in it. But it certainly comes too late when we have raised the issue in the trial that we are entitled clearly to the judgment of this Court because of the admissions made in the pleading; it certainly comes too late then to try to bring a new suit or a new case.

The Court: Well, shall we take an adjournment at this time until what hour?

Mr. Wild: What is convenient to your Honor—two o'clock?

The Court: Well, two o'clock is convenient, but then I want to finish this case this week if I can.

Mr. Atherton: Well, let's say 1:30, your Honor.

The Court: All right, 1:30.

Mr. Wild: I think we will proceed very rapidly with the rest.

(The Court recessed at 12:15 p.m.) [180]

#### Afternoon Session

Mr. Wild: Ready to proceed, your Honor.

The Court: Yes.

Mr. Wild: At this time I'd like to temporarily withdraw Mr. Sherwood Lowrey and have Mr. Eichelberger resume the stand.



HAROLD C. EICHELBERGER

a witness on behalf of the Plaintiff, having previously been sworn, resumed and testified further as follows:

Direct Examination

By Mr. Wild:

Q. Will you please state your full name again?

A. Harold C. Eichelberger.

Q. And you said this morning that you were assistant secretary also of the American Factors, Limited?      A. That's correct.

Q. And as such, you have under your custody and control the minute books of the directors and stockholders meetings of American Factors, Limited?

A. That's right.

Q. I will ask if at my request you have brought with you a minute book from the official records of the American Factors, Limited?      A. I have.

Q. And you have produced it in court here? What is [181] that minute book?

A. It is a book containing the minutes of the directors and stockholders meetings of American Factors, Limited, for a period December 27, 1922, to March 4, 1935. It contains an official and true record of the transactions.

The Court: What dates?

A. It contains the minutes for the period December 27, 1922, to March 4, 1935.

The Court: '22?

The Witness: 1922.

Mr. Wild: I'd like to withdraw Mr. Eichelberger and keep the book for a minute.

(Witness excused.)

WALTER T. VORFELD

a witness in behalf of the Plaintiff, being duly sworn, testified as follows:

Direct Examination

By Mr. Wild:

Q. Will you please state your full name?

A. Walter T. Vorfeld, V-o-r-f-e-l-d.

Q. And are you an official of American Factors, Limited?

A. I am presently the treasurer of American Factors, Limited.

Q. And in the year 1932 and before, what were you?

A. Beginning in the early part of 1931, I was secretary of American Factors and continued in that capacity until April [1932] of this year.

Q. You have seen this book which Mr. Eichelberger has identified? You know what that book is?

A. Yes, this is the minute book of American Factors for the period December 27, 1922, until March 4, 1935, containing the records, accurate and true records of the proceedings of stockholders and directors meetings of American Factors, Limited, as they were kept in the ordinary course of business.

Q. Very well. I will ask you whether or not you

(Testimony of Walter T. Vorfeld.)

have among those minutes, records of a stockholders meeting, annual meeting of stockholders of American Factors, Limited, held on March 4, 1932?

A. There is a record of such a meeting in this book.

Q. I will ask you whether or not, there is any reference in the text of that meeting to the Hackfeld litigation expense issue? A. There is.

Q. And where does it appear, on what page of that book?

A. It appears at page 224, starting with the last paragraph.

Q. And have you compared the statement with Exhibit 2-A annexed to P-5? A. Yes, I have.

Q. And is that annexed to P-5 as Exhibit 2 a true and [183] correct copy of the minutes?

A. It is.

Mr. Wild: We offer those in evidence as a true and correct copy of the minutes of American Factors of that special meeting kept in the ordinary course of business.

Mr. Atherton: No objection. We already stipulated it was.

Mr. Wild: I did not so understand. Very well.

The Court: Exhibit what? What is it you have got there?

The Clerk: P-5.

The Court: It is merely a clarification of P-5? Where does that appear in P-5?

Mr. Wild: That is Exhibit 2, your Honor.

(Testimony of Walter T. Vorfeld.)

The Court: Yes, on Exhibit 2.

Mr. Wild: Exhibit 2 on P-5.

(Witness excused.)

Mr. Wild: All right, Mr. Lowrey, will you resume the stand? That is an exhibit that records officially the meeting, the opinions of Mr. Sutro on the legal effect; and Smith, Wild, Beebe and Cades on the two other effects.

The Court: Well, this doesn't disclose what Mr. Sutro's opinion was. His opinion isn't attached to this.

Mr. Wild: No, it makes an oral report of it, though, your Honor. It says here that,

"President Bottomley stated further that this matter [184] was taken up with Mr. Oscar Sutro, attorney for the Company during the litigation, and that he feels that the whole structure of the Company was involved in the claims made by Mr. Nylen and that the litigation expenses should be paid by the Company."

That is his statement as officially recorded, showing the legal liability.

Now, I am through with the direct examination of Mr. Lowrey on this issue, your Honor.

SHERWOOD M. LOWREY

a witness in behalf of the Plaintiff, having previously been sworn, resumed and testified further as follows:

Cross-Examination

By Mr. Atherton:

Q. Mr. Lowrey, who were the members of the so-called steering committee?

A. A. W. T. Bottomley, Charles R. Hemenway, F. C. Atherton and R. A. Cooke.

Q. Did that committee hold any formal meetings?

A. If you mean formal meetings whereby records of minutes were kept, my answer is none that I know of. They met together from time to time to reach a decision among themselves and proceeded accordingly.

Q. Do you know whether any of the 23 co-defendants who were represented by this special steering committee [185] communicated to this so-called steering committee that they in any way expected to be reimbursed by American Factors for their share of the litigation expenses in the Hackfeld suit?

A. I would have no knowledge of what the conversations were between the steering committee and the other individuals unless I happened to be present or had been told about it.

Q. Do you know whether or not any of these 23 co-defendants communicated to American Factors



(Testimony of Sherwood M. Lowrey.)

any request that they be reimbursed for their share of the litigation expenses?

A. No, the whole thing was in such an upset condition that questions were all left up in the air. There was a question of getting action to defend themselves and the company. And they started when the suit was finally brought against them.

Q. You testified, I believe, that the steering committee delegated to you certain powers to make payments of small items of the expenses and that with respect to the larger items the steering committee assumed that responsibility itself and made payments.

Mr. Wild: I object to that as an unfair statement of this witness' testimony. This witness testified that the steering committee was the committee that was fully authorized under the agreement to make the determinations, and that that [186] steering committee did make determinations on all major matters.

Mr. Atherton: Your Honor, I had the reporter read back to me from the notes this morning and I took down in shorthand what he stated to me was the testimony of Mr. Lowrey, and I will read my notes verbatim which substantially the reporter said to me. He said that Mr. Lowrey testified that the steering committee delegated certain powers on the payment of the items, and that by formal action of the committee—well, I am a little garbled on my

(Testimony of Sherwood M. Lowrey.)

notes so I won't try to read them, so that I ask that my comments be stricken.

Q. Do you have any knowledge, Mr. Lowrey, as to how this so-called steering committee was authorized by these 23 co-defendants to represent them with respect to the disbursements of these litigation expenses?

A. Decisions had to be reached as to who was going to represent the group; decisions had to be reached how the case was to proceed; decisions had to be reached as to what the fees and costs of the major items were to be. And as these various subjects came up, it was discussed by that committee and decisions reached.

Q. How was the committee appointed? Do you know how the committee was actually appointed?

A. I don't remember other than that document that has been submitted. [187]

Q. What document?

A. The document that has been submitted here whereby these men were appointed to handle the things. I forget which exhibit that is. It is in this case some place here.

Mr. Wild: I can tell you. It is Exhibit 1 annexed to P-5. I think it will show Exhibit 1 annexed to P-5 as the agreement under which the defendants other than American Factors agreed to pay all the expense of the Hackfeld litigation which was incurred or approved by this steering commit-

(Testimony of Sherwood M. Lowrey.)

tee. And it is Exhibit 1. We have the original, we have the original exhibit in the courtroom.

Mr. Atherton: Off the record will you show me here something with reference to the steering committee in here?

Mr. Wild: Yes. The witness has testified——

Mr. Atherton: Never mind the witness' testimony. What does this document say?

Mr. Wild: The cost of expenses, and so forth, and so forth, and so forth; the cost and expenses are such as are set forth and "any three of them acting in the name or on behalf of all of them have already paid or incurred or shall or may hereafter pay or incur in or about or in connection with the defense . . ." And he testified that that was called the steering committee. This committee that acted is described in paragraph 2 of Exhibit 1. This witness on direct examination testified that they always called that the [188] steering committee.

Q. (By Mr. Atherton): Did the steering committee instruct you, Mr. Lowrey, with respect to refunding or repaying to the 23 co-defendants whom they represented this \$396,000?

A. No, I don't think the steering committee did at that time. I think after the action was taken by the board of directors of American Factors it was just a natural course of events where it was decided that the Factors would take and assume all expenses to take and reimburse to those 23 respondents who

(Testimony of Sherwood M. Lowrey.)

had contributed the same amount that they had paid in.

Q. Well, you don't know, then, as a matter of fact, whether any of these co-defendants ever demanded reimbursement of their share of the legal expenses?

A. No, I do not. I know no instance where anybody demanded the return of the money.

Mr. Atherton: Well, that's all.

Mr. Wild: No further questions. Just one second. No further questions of this witness. Now that closes our oral testimony. Oh, yes, I do want to ask one other question, I think, but I am not sure that it appears in the record.

Redirect Examination

By Mr. Wild:

Q. At this time all of the men in the so-called steering [189] committee are dead?

A. Correct.

Q. And of the signers, Judge Waterhouse——

A. Dead.

Q. R. A. Cooke?                      A. Dead.

Q. F. C. Atherton?                      A. Dead.

Q. F. C. Atherton again. Charles A. Atherton?

A. Dead.

Q. F. G. Lowrey?                      A. Alive.

Q. How old is he?                      A. Eighty-nine.

Q. Is he in any condition to testify in this Court at the present time?                      A. No.

Q. George Sherman?                      A. Dead.

(Testimony of Sherwood M. Lowrey.)

Q. C. H. Cooke? A. Dead.

Q. Of course Allen T. Bottomley is gone?

A. Yes.

Q. G. P. Wilcox? A. He is alive. [190]

Q. G. N. Wilcox? A. Dead.

Q. S. W. Wilcox? A. Dead.

Q. Wallace M. Alexander? A. Dead.

Q. W. M. Alexander, the same?

A. The same.

Q. E. D. Tenney A. Dead.

Q. The others are on the coast, I think, isn't that true?

A. Some are. Andrew Welch is dead. I don't know what other names appear on that corporation list.

Q. W. P. Roth? (Showing document to the witness.) A. Both alive so far as I know.

Q. But they are at present outside of the jurisdiction of the Court? A. Yes.

Mr. Wild: No further questions. Do you have oral testimony?

Mr. Atherton: No, we do not.

Mr. Wild: May we turn to the second issue in the case?

The Court: Are you through with the witness?

Mr. Wild: I am on this issue, unless your Honor wants [191] to ask questions.

The Court: No.

Mr. Wild: I did want to take up just one little



(Testimony of Sherwood M. Lowrey.)

issue about the pensions before we go into the other. But that is on a new issue.

Mr. Atherton: If you want to use the witness, use him, unless he wants to go home.

Mr. Wild: He is coming down with a cold, but he is a witness on the other issues.

Mr. Atherton: On the Henry Waterhouse?

Mr. Wild: And on the pension issue.

Mr. Atherton: Well, adjust it yourself for your convenience.

Mr. Wild: There are two additional issues in this cause. They are covered in stipulation number one, your Honor. At this time, just as a preliminary—we had an understanding that we would have the representatives of Alexander and Baldwin here when we started. I was going to offer the whole stipulation in evidence because I understood from this morning's discussion that it will probably be half past two or three.

The Court: Well, they are familiar with the stipulation, I assume.

Mr. Wild: Yes, I think so.

The Court: I don't know what knowledge they could glean or what interest they could protect by being here while you [192] read the stipulation.

Mr. Wild: Well, what I want to do, if it meets with your Honor's approval, is this: This witness stated that he was running a temperature and he believed he was coming down with a cold, and I wanted to just offer stipulation one in evidence

(Testimony of Sherwood M. Lowrey.)

now without reading it, without making any opening statement. And the Government has agreed to make no contention about that. Then I'd have this witness testify concerning the two issues that are raised there. One is the pension; the other is the Waterhouse Trust note. And we could excuse him and he can go home and go to bed.

The Court: All right. You may proceed along those lines. I understand it is agreeable to the Government.

Mr. Wild: Yes, it is agreeable. But we had promised Mr. Pratt that is one of the issues and that we would call him when we got to that issue. He was coming up here at half past two or three.

The Court: Well, your associate could step to the telephone outside and call him up, and in the meantime——

Mr. Wild: In the meantime if I can go ahead without any opening statement.

Mr. Atherton: Let me clarify something right here, your Honor, for the record. If it be that Alexander and Baldwin are going to file a separate stipulation on the Waterhouse note, it will be substantially the same as that which I [193] understand Mr. Wild is going to offer with respect to the American Factors, with a slight variance that one of the paragraphs in the A and B stipulation will show that it charged off on its books \$25,000 of the \$50,000 in 1931 and charged off the balance of the \$25,000 in the year 1932, but took the entire

(Testimony of Sherwood M. Lowrey.)

amount of \$50,000 as a deduction in its tax return for 1932. In other words, bookkeeping——

The Court: Well, they can make that showing or undergo an examination as to that after you finish this other.

Mr. Wild: Yes. May it please the Court, I offer in evidence at this time stipulation number one signed by counsel, and counsel has an objection which is of record and is contained in the stipulation, I think.

Mr. Atherton: Paragraph two and paragraph nine.

The Court: Are you able to furnish me with a copy of it?

Mr. Wild: Your Honor, I am going to give you the original, and I am going to ask that it be marked as P-10, your Honor.

The Court: Has it been filed in the case, because it was going to be offered in evidence?

The Clerk: Eleven.

(The document referred to was received in evidence as Plaintiff's P-11.)

(Testimony of Sherwood M. Lowrey.)

PLAINTIFF'S EXHIBIT P-11

In the United States District Court for the  
Territory of Hawaii  
Civil Action No. 419

AMERICAN FACTORS, LIMITED, A Hawai-  
ian Corporation,

Plaintiff,

vs.

AGNES M. KANNE, Executrix under the Will  
and of the Estate of Fred H. Kanne, Collec-  
tor of Internal Revenue of the United States  
for the District of Hawaii,

Defendant.

SMITH, WILD, BEEBE & CADES,

(U. E. Wild)

Fourth Floor,  
Bishop Trust Building,  
Honolulu, T. H.

Attorneys for Plaintiff.

LELAND T. ATHERTON,

Special Assistant to the Attorney General,  
Tax Division,  
Department of Justice,  
Washington, D. C.

Attorney for the Defendant.

STIPULATION I.

It is hereby stipulated by and between the par-

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

ties hereto through their respective attorneys that the following statements of fact shall be considered as true, and that either party may offer in evidence, oral testimony or any additional evidence, documentary or otherwise not inconsistent with the facts herein stipulated.

### I.

That American Factors, Limited, the Plaintiff herein, is a corporation, incorporated under the laws of the Territory of Hawaii, having its principal office in Honolulu, City and County of Honolulu, Territory of Hawaii; that Fred H. Kanne was the Collector of Internal Revenue of the United States for the District of Hawaii, and a resident of said Honolulu at all times from on or about August 1, 1933 until his death on December 24, 1946; that Agnes M. Kanne, the duly qualified and appointed Executrix of the Will and of the Estate of Fred H. Kanne, deceased, was substituted as Defendant in the above entitled cause by order of the above entitled court on March 6, 1947.

### II.

American Factors, Limited, at the end of the calendar year 1930 had a capital of \$10,000,000.00, and its books showed a surplus and undivided profits of \$5,971,049.93 or a total capital and book surplus of \$15,971,049.93. At the end of the calen-



(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

dar year 1930, and during the entire calendar year 1931, American Factors, Limited, was agent for thirteen sugar plantations and other corporations located in and carrying on business in the Hawaiian Islands, which corporations, according to their books and annual reports, had a total capital of \$26,944,720.00 and a total surplus and undivided profits of \$21,411,420.24, or a total capital and surplus as of December 31, 1930 of \$48,356,140.24. On December 30, 1930, American Factors, Limited, and the companies for which it served as agent had on deposit in the banks of the Territory of Hawaii at least a total sum of \$1,741,696.24. The Defendant objects to admissibility in evidence of the aforesaid facts on the ground of their immateriality and irrelevance.

III.

The Henry Waterhouse Trust Company, Limited (hereinafter called the Waterhouse Company), was incorporated under the laws of the Territory of Hawaii on November 26, 1902, to engage in the business usual and permitted to a trust company under the laws of the territory. In addition to engaging in the usual fiduciary business common to all trust companies, it operated a plantation agency department, a real estate department, a stock and bond brokerage department, and an insurance department, and at times invested in

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

stocks and bonds to a limited extent on its own account, these various activities being permissible under the Hawaiian statutes.

#### IV.

In the middle of October, 1930, Waterhouse increased its capital stock from \$200,000 to \$400,000, consisting of 4,000 shares of a par value of \$100 each. The new shares were all taken by the old stockholders who paid for them in cash at par. In November the effects of the general business depression began to be felt in the Territory of Hawaii, and as a large part of the Waterhouse assets consisted of real estate and mortgages, its secretary became apprehensive that if many calls were made on its demand accounts the Company's financial condition would not be sufficiently liquid to meet its cash requirements. He discussed the situation with the treasurer and auditor of Waterhouse and then advised the management of Bishop Trust Company, Limited, hereinafter called Bishop Trust, that a sale of the stock might be arranged, suggesting a price of \$100 each or more for the shares.

#### V.

An Audit Report dated March 31, 1931 signed H. C. Tennent and Co. by E. J. Greaney disclosed the book value of assets of the Waterhouse Company as of February 14, 1931 to be in the amount

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

of \$4,820,090.92 and the liabilities, exclusive of capital and surplus, to be in the amount of \$4,149,437.06. This Audit Report contained the following statement:

“The Contingent Reserve (for losses) of \$680,803.15 and the Special Contingent Reserve of \$400,000.00 referred to above, are considered adequate to cover probable losses in the realization of the assets and liquidation of liabilities.”

It is also stated in the Report that the principal purpose of the Audit was to establish as accurately as possible the total assets and liabilities as of February 14, 1931, the date control of the Company passed to the Bishop Trust Company, Limited, through its acquiring all of the stock of the Waterhouse Company.

It is also stated in the Report that Exhibit A attached thereto, a copy of which is hereunto annexed and made a part hereof as Exhibit A, shows the Capital and Surplus of the Waterhouse Company as of February 14, 1931, before adjustment, the total estimated losses finally agreed upon as acceptable to the Bishop Trust Company, Limited, and the manner of arriving at the Contingent Reserve (for Losses) and the Special Contingent Reserve. In this connection, the Report states, by way of explanation of said Exhibit A, that the balance sheet shows the Profit and Loss account with a debit balance of \$400,000.00 offset against

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

the Contingent Reserve (for Losses); and that this appears as preferable for balance sheet purposes to the alternative of clearing the Capital Stock Account, and produces the same net result.

By way of explanation of Exhibit D attached to the Report, it is stated that the Special Contingent Reserve, as shown in Exhibit A above, will remain intact until actual losses written off have fully exhausted the Contingent Reserve (for Losses) of \$779,717.23; and that additional losses as determined will then be applied pro rata against the Special Contingent Reserve contributions.

## VI.

Mr. A. W. T. Bottomley, president of American Factors, Limited, and of the Bishop First National Bank of Honolulu and vice-president of the Bishop Trust Company, Limited, called a conference of the heads of the four Hawaiian sugar agencies, the president of the Bank of Hawaii, Limited, the president of the Hawaiian Trust Company, Limited, and two members of the finance committee of the Bishop Trust Company, Limited, to present to them the financial condition of the Waterhouse Company and discuss the feasibility of making some plan to prevent the Waterhouse Company from being forced into liquidation.

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

VII.

The Waterhouse Company was conducting business as usual but was encountering some financial difficulties; economic conditions were not clear, and after the investigation, the executives of the Bishop Trust Company, Limited, wished to look further into the matter before acting. After February 1, 1931, the Bishop Trust Company, Limited, advised the Waterhouse Company shareholders that it would not pay cash for their shares as had previously been suggested. On Saturday, February 14, 1931, Mr. W. F. Frear, president of the Bishop Trust Company, Limited, at a meeting of the board of directors of that company made a statement which was recorded on the minutes as follows:

“This is a special meeting called to consider a proposition to take over the Henry Waterhouse Trust Co., Ltd. At first it was a proposition to purchase the stock of that company, somewhat as we purchased the stock of the Pacific Trust Co., but as a result of investigation, it changed largely to a salvage proposition.

“The plan now is for our Company to acquire all the stock of the Waterhouse Trust Co. without cost; for Mr. and Mrs. R. W. Shingle and Mr. A. N. Campbell, in settlement of their indebtedness to the Company, to pay into it \$535,000.00 and to convey to its order their respective 18% and



(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

10% undivided interests in certain land, fish ponds and fishery at Kalihi, the same to be sold for \$87,000.00 and the proceeds, with \$13,000.00 additional contributed by the Bishop Trust Co., to make up an even \$100,000.00, to be paid into the Waterhouse Trust Co., making in all \$635,000.00 thus paid in. In addition, a number of corporations and individuals are to contribute various sums aggregating \$400,000.00, thus making altogether \$1,035,000.00 of cash to be paid into the Waterhouse Trust Co. The Bishop Trust Co. is to pay such amount, if any, as may be required in addition to enable the Waterhouse Trust Company to meet its liabilities, but it is hoped that no such contribution will be required. That, however, remains to be seen.

“The Bishop Trust Co. is to take over, without other cost, the business of the Waterhouse Trust Co., other than the assets and liabilities, and to operate such business at its own expense and for its own benefit. This will include the trusts, executorships, agencies, insurance, safe deposit business, etc., with the necessary furniture, equipment and supplies therefor. It is hoped also that the Bishop Trust Co., will profit through making new contacts. The stock and bond and real estate departments will probably be discontinued.

“The assets and liabilities of the Waterhouse Trust Co. are to be gradually liquidated by applying the assets to the liabilities, together with the

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

expenses of liquidation, including \$1,000.00 a month to be paid to the Bishop Trust Co. for supervision.

“In final settlement, if there is an excess of assets over liabilities, it is to be applied, first, to the reimbursement of the amount, if any, that may be contributed by the Bishop Trust Co. in addition to the \$1,035,000.00, and, secondly, pro rata to the contributors of the \$400,000.00 with simple interest at 4%, and, thirdly, the balance, if any, to go to the Bishop Trust Co.

“There are three objects: First, to prevent the failure of such a company as the Waterhouse Trust Co., with the consequent general disastrous effects; secondly, to prevent loss on the part of many who have entrusted their money to the Company for investment and who can ill afford the loss; and, thirdly, to enable the Bishop Trust Co. to acquire new business. These three objects naturally appeal with different degrees of force to different groups of contributors.”

The plan, as outlined, was approved by the Board of directors of the Bishop Trust Company, Limited, at that meeting. The transactions mentioned in the second paragraph of Mr. Frear's statement, *supra*, were duly performed within a few days after February 14, 1931.

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

### VIII.

Prior to the consummation of the transactions hereinbefore mentioned, the following individuals and corporations promised to pay to the Waterhouse Company, upon consummation of the proposed plan, the sums of money set opposite their names, to wit:

Name of Contributor	Amount Paid
The Bishop Company, Limited . . . . .	\$100,000
American Factors, Limited . . . . .	50,000
Alexander & Baldwin, Limited . . . . .	50,000
Castle & Cooke, Limited . . . . .	50,000
W. R. Castle . . . . .	50,000
Beatrice Castle Newcomb . . . . .	50,000
Bank of Hawaii . . . . .	25,000
Hawaiian Trust Company, Limited . . .	25,000
Total . . . . .	<hr/> \$400,000

### IX.

Annexed hereto as Exhibit B and made a part hereof is an excerpt from the minutes of the meeting of the Board of Directors of American Factors, Limited, held on March 2, 1931, authorizing the aforesaid payment of \$50,000 to the Waterhouse Company. There are also annexed hereto and made a part hereof as Exhibits C, D, E, F and G, excerpts from the minutes of the Directors' meetings of the

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

corporations who made their respective payments to the aforesaid \$400,000 fund of the Waterhouse Company.

## X.

The plan of reorganization of the Waterhouse Company was carried out as outlined above, and the individuals and corporations whose names appear in the preceding paragraph of this stipulation actually paid into the Waterhouse Company the amounts of money stated opposite their respective names upon the provisions concerning the repayment thereof as more particularly stated in the letters to Plaintiff dated February 21, 1931, and February 24, 1931, copies of which are attached hereto and made a part hereof as Exhibits H and I, respectively. Letters identical in form as Exhibits H and I were addressed to each of the individuals and corporations that made payments to the Waterhouse Company aggregating \$400,000, and said letters were duly received by each such individual and corporation.

## XI.

Attached hereto and made a part hereof for all purposes and marked Exhibit J is a true copy of a promissory note executed and delivered by the Waterhouse Company to Plaintiff in the principal sum of \$50,000.00, being the note referred to in said letter, Exhibit H. Notes identical in form were executed and delivered by the Waterhouse Company

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

to each such other corporation and to each such individual, which said notes were in each instance for the principal sum of money as stated opposite the name of the respective individuals and corporations hereinbefore stated.

XII.

The actual owners of the capital stock of the Waterhouse Company on February 14, 1931, shortly prior to the transfer of the stock of that company to the Bishop Trust Company, Limited, were as follows:

Stockholder	Shares	Par Value
A. N. Campbell .....	1,235	\$123,500.00
R. W. Shingle .....	1,235	123,500.00
A. L. Castle .....	700	70,000.00
J. K. Clarke .....	480	48,000.00
Harriet E. Wight .....	100	10,000.00
C. L. Wight .....	100	10,000.00
Marietta Withington .....	50	5,000.00
Arthur Withington .....	50	5,000.00
Estate of E. M. Lewis .....	50	5,000.00
Total .....	4,000	\$400,000.00

XIII.

The four stockholders whose names appear first on the above list, namely, A. N. Campbell, R. W. Shingle, A. L. Castle and J. K. Clarke, were di-



(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

rectors of the Waterhouse Company. Mr. W. R. Castle, father of A. L. Castle, purchased from the stockholders, other than Messrs. Campbell, Shingle and Clarke, their shares of the capital stock of the Waterhouse Company as follows:

Stockholders	Shares	Par Value
Harriet E. Wight .....	100	\$10,000.00
Charles L. Wight .....	100	10,000.00
Marietta Withington .....	50	5,000.00
Arthur Withington .....	50	5,000.00
Estate of E. M. Lewis .....	50	5,000.00
<hr/>		<hr/>
Total .....	350	\$35,000.00

Thus, on February 14, 1931, the following persons were the stockholders of the Waterhouse Company, and they were the owners of the number of shares shown opposite their names, to wit:

Stockholder	Shares	Par Value
A. N. Campbell .....	1,235	\$123,500.00
R. W. Shingle .....	1,235	123,500.00
A. L. Castle .....	700	70,000.00
W. R. Castle .....	350	35,000.00
J. K. Clarke .....	480	48,000.00
<hr/>		<hr/>
Total .....	4,000	\$400,000.00

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

#### XIV.

The \$400,000 par value of capital stock of the Waterhouse Company was transferred by the aforesaid stockholders to the Bishop Trust Company, Limited, as of February 14, 1931, and the cash balances, properties, stocks and bonds, accounts, books and records of the Waterhouse Company came under the management and control of the new stockholder, the Bishop Trust Company, Limited. New officers and directors were elected, a finance committee, comprised of officers and directors, and an advisory committee comprised of representatives of the \$400,000 noteholders, were appointed, and work was immediately commenced on the liquidation of the Waterhouse Company.

#### XV.

There is annexed hereto as Exhibit K and made a part hereof condensed balance sheets of the Waterhouse Company as at February 14, 1931, before and after the reorganization.

#### XVI.

On May 29, 1931, the vice-president and manager of the Bishop Trust Company, Limited, who was also a director of the Waterhouse Company, stated to the board of directors of the Bishop Trust Company, Limited, that the operation of the Waterhouse Company business was causing a monthly

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

loss "as it is in the nature of a receivership." He added the belief that "the bulk of the work in straightening out the affairs of the company will be accomplished within a year or two." At a meeting of June 26, 1931, he advised the board of directors of the Bishop Trust Company, Limited, that:

"\* \* \* he had made a recommendation to the Bishop Trust Company of a transfer of all of the work of the Waterhouse Trust Company directly to the Bishop Trust Company, with the exception of the collection agency end of the business."

At the same time he stated his belief that the Bishop Trust Company, Limited, would suffer no loss if business should again become normal. Thereupon the Bishop Trust Company, Limited, took over some of the Waterhouse Company business, but the Waterhouse Company continued to do some business until it, the Guardian Trust Company, Limited, and the Pacific Trust Company, Limited, were formally merged into the Bishop Trust Company, Limited, on December 30, 1933 as hereinafter set forth.

## XVII.

There is annexed hereto as Exhibit L and made a part hereof condensed balance sheets of the Waterhouse Company as at December 31, 1931, and December 31, 1932.

## XVIII.

The advisory committee referred to in Exhibit

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

I was composed of prominent business and professional men who represented the aforesaid note holders who had made payments into the aforesaid \$400,000.00 fund. The original committee consisted of:

1. A. W. T. Bottomley (now deceased) whose alternates were S. M. Lowrey, who was then Plaintiff's treasurer, and H. A. Walker who is now president of the Plaintiff.

2. C. H. Cooke, then president of the Bank of Hawaii, Limited, whose alternates were R. McCorriston, now a vice-president of the Bank of Hawaii, Limited, G. G. Fuller, now retired, who was a vice-president of the Bank of Hawaii until his retirement, and E. W. Carden who is now president of the Bank of Hawaii.

3. A. L. Castle, an attorney at law, at present a partner in the firm of Robertson, Castle & Anthony, whose alternates were F. C. Atherton (now deceased) then the president of Castle & Cooke, Limited, and A. G. Budge, now president of Castle & Cooke, Limited.

The composition of the advisory committee changed from time to time thereafter and among the other persons who attended meetings as a member of the committee was: James L. Cockburn who was then the executive vice-president of Bishop & Company, Limited.

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

This committee met frequently with the finance committee of the Waterhouse Company and passed upon all matters of importance affecting that Company and particularly those matters tending to affect the amount of reimbursement, if any, ultimately to be made to the special note holders. It advised with Bishop Trust Company, Limited, and its members were consulted from time to time by the Plaintiff and other special note holders.

XIX.

Under date of July 18, 1932, the Waterhouse Company, over the signature of M. B. Henshaw, vice-president, dispatched to the Plaintiff a letter, a true copy of which is annexed hereto as Exhibit M and made a part hereof. The defendant objects to the admissibility in evidence of Exhibit M on the following grounds, viz: (a) that the statements made therein are immaterial to any issue involved herein; and (b) that its admission in evidence for the purpose of proving the truth and accuracy of the statements made therein concerning the reappraisal of the assets and liabilities of the Waterhouse Co., and the competency and accuracy of such reappraisal would constitute a violation of the hearsay rule, and such evidence is also incompetent. Letters identical in form to Exhibit M were dispatched by the Waterhouse Company to the other noteholders and received by them. The advisory



(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

committee was not abrogated but continued to function as usual during the balance of the year 1932 and the year 1933.

XX.

During 1933 for the stated purpose of simplifying its financial structure and effecting economies, Bishop Trust Company, Limited, decided to effect a merger. Attached hereto, made a part hereof for every purpose, and marked Exhibit N is a copy of a letter dated December 19, 1933, sent by the Waterhouse Company to The Bishop Company, Limited. Letters identical in form with Exhibit N were sent to and received by each of the aforesaid Waterhouse Company noteholders.

XXI.

On December 21, 1933, a meeting of the said Waterhouse Company noteholders was held at which the holders of \$300,000 out of a total of \$400,000 of the notes outstanding were represented as follows:

Noteholder	Amount of Note Held
American Factors, Ltd., S. M. Lowrey, representative .....	\$ 50,000
Alexander & Baldwin, Ltd., C. R. Linden, representative .....	50,000
The Bishop Company, Ltd., George P. Rea, representative .....	100,000

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

W. R. Castle, Alfred L. Castle, representative .....	50,000
Alfred L. Castle, as executor under will of Beatrice Castle Newcomb, deceased, Alfred L. Castle, representative .....	50,000
Total .....	<hr/> \$300,000

The noteholders who were not represented at this meeting were:

Noteholder	Amount of Note
Castle & Cooke, Ltd. ....	\$ 50,000
Bank of Hawaii .....	25,000
Hawaiian Trust Co., Ltd. ....	25,000
Total .....	<hr/> \$100,000

Present by invitation were Messrs. C. F. Weeber and M. B. Henshaw. The minutes of the meeting record that—

“Mr. Henshaw stated that the purpose of the meeting was to consider the letters dated December 19 which had been sent out to all of the corporations and/or individuals who had loaned money to Henry Waterhouse Trust Co., Ltd., in February, 1931.” and after some discussion it was the unanimous opinion of those present that proposal No. 1 as set forth in the letters dated December 19, 1933 (Exhibit N), be approved.

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

The minutes of that meeting also record that—

“Mr. Linden suggested that after the proposed merger the Advisory Committee be continued, at least until such time as the question of whether the notes held by the underwriters become a loss in the year 1932, is definitely settled. It was the consensus of opinion that this suggestion be followed.”

## XXII.

Following the merger aforesaid, on December 30, 1933, the Bishop Trust Company, Limited, for the purpose of accounting to the aforesaid noteholders kept separate accounting records referred to as the “Waterhouse Section,” of the Waterhouse Company assets acquired and the liabilities assumed in respect thereto. Among the records so kept, a special account designated “Notes Payable—Underwriters H W T—New” was set up to cover the \$400,000 paid in by the aforesaid noteholders and the charges against it. This account at December 30, 1933, showed a credit balance of \$400,000.

## XXIII.

The following is a statement of book value of the Waterhouse Company assets, exclusive of cash, on the indicated dates, actual losses sustained on liquidation to the indicated dates, set up on the latter's books, and the estimated losses on liquidation arrived at by a group of officers of the Bishop Trust Company, Limited:

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-11—(Continued)

	Book value of assets exclusive of cash	Actual losses sustained on liquidation	Estimated loss on liquidation
Feb. 14, 1931	\$4,275,543.05	\$ —————	\$1,080,803.15
Dec. 31, 1931	3,697,746.38	324,913.77	—————
1932	2,993,234.31	410,345.80	—————
1933	2,965,675.99	571,482.80	*936,352.98

## XXIV.

Plaintiff's books of account were kept on the accrual basis of accounting, and, during the calendar years 1924-1932, inclusive, they were so kept, and its Federal Income Tax returns for those years were made on that basis of accounting. In the calendar year 1932, Plaintiff charged off on its books of account the face amount of the aforesaid \$50,000.00 Waterhouse Trust Company promissory note which was given to the Plaintiff in the year 1931, pursuant to the actual method of charging off bad debts which the plaintiff used in that taxable year and all prior taxable years for income tax purposes.

## XXV.

In its Federal Income Tax return for the taxable year 1932, at item 20 on page 1 thereof, the taxpayer took as a bad debt deduction the entire

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\*Estimate made by Bishop Trust Company's comptroller of the losses that would be sustained on the liquidation of the remaining assets.

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

amount of \$50,000 paid by it to the Waterhouse Company in 1931. The Commissioner of Internal Revenue determined that the \$50,000 paid to Henry Waterhouse Trust Company was not deductible as a bad debt deduction for the year 1932.

XXVI.

During the calendar year 1932 taxpayer paid the total sum of \$4,063.33 to the following individuals in the amounts stated opposite their names, to wit:

Payee	Amount Paid
Mrs. R. C. Walker .....	\$1,200.00
Minor children of John Frank, deceased	300.00
Minor children of W. Zablan, deceased.	240.00
Mrs. Wm. Searby .....	1,800.00
Mrs. Luddecke .....	523.33
	<hr/>
Total .....	\$4,063.33

The above payments were to widows and minor children of former employees of plaintiff.

In its federal income tax return for the taxable year 1932 taxpayer deducted the above amounts as ordinary and necessary expenses in computing its taxable net income. The Commissioner of Internal Revenue in his first deficiency letter allowed the



(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)  
deduction and in his second deficiency letter dis-  
allowed the same.

SMITH, WILD, BEEBE  
& CADES,

/s/ U. E. WILD,

/s/ MILTON CADES,

Counsel for Plaintiff.

/s/ LELAND T. ATHERTON,

Special Assistant to the Attorney General, Tax  
Division, Department of Justice,

Counsel for Defendant.

/s/ RAY J. O'BRIEN,

United States Attorney for the District of Hawaii,  
Counsel for Defendant.

#### EXHIBIT A

Henry Waterhouse Trust Co., Ltd.  
Analysis of Capital Adjustments for Reorganization

February 14th, 1931

#### Capital and Surplus Before Adjustment :

Capital Stock .....		\$400,000.00#
Surplus Earned .....	\$ 200,000.00	
Profit and Loss.....	158,575.93#	
Special Reserve .....	15,000.00	
Sundry Accounts Special.....	1,141.30	
Reserve for Taxes .....	5,000.00	
	<hr/>	
Total Surplus .....		379,717.23
		<hr/>
Total Capital and Surplus transferred to Reserve.....		\$779,717.23
		<hr/>

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-11—(Continued)

## Shingle and Campbell

Accounts Net .....	\$ 733,914.08
Estimated Losses .....	1,080,803.15

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Total (Basis for Reorganization).. \$1,814,717.23

## Payments:

R. W. Shingle .....	\$ 492,137.23
A. N. Campbell.....	142,862.77

## Total Direct

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Payments ..... \$ 635,000.00 |

## Bishop First Nat'l

Bank .....	\$ 100,000.00
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Bank of Hawaii, Ltd.	25,000.00
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Hawaiian Trust Co., Ltd. ....	25,000.00
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American Factors, Ltd. ....	50,000.00
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Alexander & Baldwin, Ltd. ....	50,000.00
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Castle & Cooke, Ltd...	50,000.00
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W. R. Castle .....	50,000.00
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Beatrice Castle Newcomb .....	50,000.00
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## Total Contingent

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Payments ..... \$ 400,000.00 |

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Total Payments ..... \$1,035,000.00

## Balance of estimated losses

to apply against reserve

created by transfer from Surplus..... \$779,717.23

# For balance sheet purposes a debit balance of \$400,000.00 is set up in the Profit and Loss Account to offset the Capital Stock Account which stands with a credit balance of \$400,000.00.

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

### EXHIBIT B

Excerpt From Minutes of Special Meeting of Board  
of Directors of American Factors, Ltd., Held  
March 2nd, 1931

“President Bottomley informed the Directors of the circumstances surrounding the taking over of the business of the Henry Waterhouse Trust Co., Ltd. by the Bishop Trust Co., Ltd. and stated that, following consultation with such of the Directors as he was able to reach in the time available, it was deemed advisable in the interests of the business community as a whole that this Company join with others in certain financing required for this transaction. President Bottomley stated further that a loan had been made to the Henry Waterhouse Trust Co., Ltd. in the amount of \$50,000.00 against its note dated February 21st, 1931, bearing 4% interest, and repayable when and if in the opinion of the officers of the Bishop Trust Co., Ltd. the sound assets of the Henry Waterhouse Trust Co., Ltd. are equal to its liabilities and asked the approval of the Directors of his action in agreeing to make this loan. On motion of Mr. Atherton, seconded by Mr. Dillingham and carried unanimously, the action of President Bottomley in authorizing the above-mentioned loan was ratified and approved.”

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

### EXHIBIT C

Excerpt From Minutes of Directors' Meeting of  
Alexander and Baldwin, Limited, Held February 25, 1931

Loan to Henry Waterhouse Trust Company, Ltd.

On motion by Mr. Galt, seconded by Dr. Dean, the loan of \$50,000.00 to the Henry Waterhouse Trust Company Limited, which had been made with the informal approval of a majority of the Board, was also formally ratified and confirmed.

### EXHIBIT D

Excerpt From Minutes of Directors' Meeting of  
Hawaiian Trust Company, Limited, Held February 26, 1931

Loan to Henry Waterhouse Trust Company, Ltd.

President Galt stated that he had been reliably informed that Henry Waterhouse Trust Company, Ltd. had become seriously involved financially, and that our company and others had rendered assistance; our company to the extent of a \$25,000.00 loan, in order to protect the four or five hundred depositors of the Henry Waterhouse Trust Company.

Director Hemenway moved that this loan of \$25,000.00 to Henry Waterhouse Trust Company, Limited, be approved. The motion was seconded by Director McInerny and carried unanimously.

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

### EXHIBIT E

Excerpt From Minutes of Directors' Meeting of  
Castle and Cooke, Limited, Held March 5, 1931

President F. C. Atherton referred to the letter circulated among the Directors under date of February 24, 1931 (copy appended hereto) recommending that the sum of \$50,000.00 be loaned to the Henry Waterhouse Trust Company, Limited, to prevent that company from going into bankruptcy and thus causing widespread financial losses throughout the community. Although this loan had been informally approved by the Directors, in view of the importance of the subject it would seem advisable to take formal action at this time approving and ratifying the original action and also placing the foregoing letter in the records of the Company.

It was moved by Director Atherton Richards and seconded by Director H. K. L. Castle that the Directors hereby formally ratify and approve their action taken informally under date of February 24, 1931, authorizing a loan of \$50,000.00 to the Henry Waterhouse Trust Company, Limited, in conjunction with other loans to the said Company by other business houses of this city, and that the letter of President F. C. Atherton to the Directors referred to above be placed on record in the Minute Book; that in view of the rumors which



(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

are in circulation in the community regarding the financial condition of the said Henry Waterhouse Trust Company, Limited, the proper officers of this company are hereby requested to ask the Territorial Government to make such review of the transactions and records of the Henry Waterhouse Trust Company, Limited, as is deemed appropriate and desirable.

Carried.

EXHIBIT F

Excerpt From Minutes of Directors' Meeting of  
the Bishop Company, Limited, Held March 12,  
1931

“It was moved by Director John Waterhouse, seconded by Director Ellis and unanimously carried

“That the loan to Henry Waterhouse Trust Company, Limited, of \$100,000.00 at four per cent, on conditional note of the company, be and the same hereby is approved and confirmed and that copies of the note and letters as submitted outlining terms and conditions of repayment of the note be incorporated in these minutes.”

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

### EXHIBIT G

Excerpt From Minutes of Directors' Meeting of  
Bank of Hawaii Held March 12, 1931

“The President read \* \* \* Report of the Advisory Committee of March 11, 1931, in which no comments were made on the loans granted from February 15th to 28th, 1931. The Committee called the attention of the Directors to the Loan of \$25,000.00 to the Henry Waterhouse Trust Company, Limited, at a special rate of interest—4%.”

### EXHIBIT H

Henry Waterhouse Trust Company

Limited

P. O. Box 3410

Honolulu, Hawaii

February 21, 1931.

American Factors, Ltd.,

Honolulu, T. H.

Gentlemen:

We outline as follows the plan in regard to the Henry Waterhouse Trust Company, Limited.

1. The Bishop Trust Co., Ltd., has acquired all of the capital stock of the Henry Waterhouse Trust Co., Ltd.

2. In settlement of their indebtedness to the Henry Waterhouse Trust Co., Ltd., R. W. Shingle

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

and wife have paid into that Company \$435,000.00; A. N. Campbell has paid into it \$100,000.00; and R. W. Shingle and A. N. Campbell are to convey to the Company or to its order their respective 18% and 10% undivided interests in certain land, fish ponds and fishery at and near Mokauea, Kalihi-kai, Honolulu, the same to be sold and the proceeds thereof, plus such additional sum (to be contributed by Bishop Trust Co., Ltd.) as shall be necessary to make a total of \$100,000.00, to be paid to the Henry Waterhouse Trust Co., Ltd.

3. The following corporations and individuals have contributed or are to contribute the following sums to the Henry Waterhouse Trust Co., Ltd.; The Bishop Co., Ltd., \$100,000.00; American Factors, Ltd., Alexander & Baldwin, Ltd., Castle & Cooke, Ltd., W. R. Castle and Beatrice Castle Newcomb each \$50,000.00; and the Bank of Hawaii, Ltd., and the Hawaiian Trust Co., Ltd., each \$25,000.00. For the amounts of these contributions notes of the Henry Waterhouse Trust Co., Ltd., of even date herewith, bearing simple interest at the rate of four per cent (4%) per annum, have been or will be given to the respective contributors, payable, however, only as provided in paragraph 8.

4. The Bishop Trust Co., Ltd., will ultimately contribute such amount, if any, over the above sums aggregating \$1,035,000.00, as may be required to

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

liquidate the liabilities (other than the sums or notes mentioned in paragraph 3) of the Henry Waterhouse Trust Co., Ltd.

5. The Bishop Trust Co., Ltd., will take over, own and operate at its own expense and for its own benefit, in its own name or in the name of the Henry Waterhouse Trust Co., Ltd., the business (with such of the furniture, equipment and supplies as shall be required therefor) other than the assets subject to the liabilities (referred to in paragraph 6) of the Henry Waterhouse Trust Co., Ltd. Any of the business so taken over by the Bishop Trust Co., Ltd., may by it be discontinued, sold or merged with its other business.

6. The assets and liabilities of the Henry Waterhouse Trust Co., Ltd., will gradually be liquidated by applying the assets or their proceeds and the income therefrom to (a) the expenses involved in such liquidation (such as salaries, taxes, rent, insurance, legal, auditing, bank examiner, postage, cables, books, stationery, etc.); (b) \$1,000.00 per month to the Bishop Trust Co., Ltd., for overhead or supervision; (c) interest payable; (d) indebtedness; and (e) other liabilities, if any. The assets shall be deemed to include cash on hand, bank deposits, notes and accounts receivable, stocks and bonds, stock exchange seat, and furniture, equipment and supplies (except as otherwise provided

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

in paragraph 5) owned by the Henry Waterhouse Trust Co., Ltd., at the close of business on February 14, 1931, and the sums since paid or to be paid in as set forth in paragraphs 2, 3 and 4; the liabilities shall be deemed to include all liabilities of the Company as of that date; and liabilities subsequently incurred in connection with the liquidation; the expenses of operation shall be deemed to include, besides other items, the cost of investigation by accountants preliminary to the reorganization, the cost of an audit of the Company's affairs and of the set-up of the accounting system at the outset by accountants, a proper pro rata of salaries of officers and employees of the Bishop Trust Co., Ltd., transferred temporarily for the reorganization, rehabilitation and readjustment of the affairs of the Henry Waterhouse Trust Co., Ltd., at the outset and a proper pro rata of the salaries of officers and employees of the Henry Waterhouse Trust Co., Ltd., so long as their services are rendered in part in connection with the liquidation and in part in connection with the business taken over by the Bishop Trust Co., Ltd. It is proposed, for convenience, efficiency and economy, to transfer the various branches of the business to the Bishop Trust Building as soon as the circumstances warrant.

7. In final settlement, the excess, if any, of the assets as defined in paragraph 6 or their proceeds



(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

and the income therefrom over the payments specified in paragraph 6 is to be applied, so far as it will go, in the following order of priority: First, to reimbursing the Bishop Trust Co., Ltd., for such amount, if any, without interest as may be contributed by it under paragraph 4 above; secondly, to paying pro rata, principal and interest, the notes mentioned in paragraph 3, and thirdly, the balance, if any, of such excess to be paid to the Bishop Trust Co., Ltd.

8. The Henry Waterhouse Trust Co., Ltd., may from time to time borrow money (from the Bishop Trust Co., Ltd., and/or others) to meet its requirements in connection with the liquidation and repay the same with interest. The notes (principal and interest) mentioned in paragraph 3 shall be payable only if and to the extent that there shall be an excess of assets available therefor in final settlement after the payments specified in paragraph 6 and the reimbursement of the Bishop Trust Co., Ltd., provided for in subdivision First of paragraph 7. The books of the Henry Waterhouse Trust Co., Ltd., shall be closed at the end of each calendar half year and a financial statement for such half year shall thereupon be furnished to each of the contributors named in paragraph 3. Such contrib-

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

utors shall have the right to inspect the books of the Company at all reasonable times.

Very truly yours,

HENRY WATERHOUSE  
TRUST CO., LIMITED,

By /s/ W. F. FREAR,  
Its President.

By /s/ W. A. WHITE,  
Its Treasurer.

Approved:

BISHOP TRUST COMPANY,  
LIMITED,

By /s/ W. F. FREAR,  
Its President.

By /s/ E. W. SUTTON,  
Its Treasurer.

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

### EXHIBIT I

Henry Waterhouse Trust Company,  
Limited

P. O. Box 3410  
Honolulu, Hawaii

February 24, 1931

American Factors, Ltd.,  
Honolulu, T. H.

Gentlemen:

Supplementing our letter of the 21st instant in regard to the Henry Waterhouse Trust Co., Ltd.:

1. There is a Finance Committee, consisting at present of M. B. Henshaw, J. L. Cockburn and E. W. Sutton, for frequent consultation on numerous matters, including many that naturally it would be impracticable to bring before the Advisory Committee referred to in the next paragraph.

2. There will be an Advisory Committee for passing upon various matters of importance, particularly those tending to affect the amount of reimbursement, if any, ultimately to be made to the contributors mentioned in paragraph 3 of the letter above referred to—such matters as sales of stocks and bonds owned by the Company, compromises of claims by or against the Company, etc. This Committee will consist for the present of

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

A. W. T. Bottomley, C. H. Cooke and A. L. Castle, with alternates as follows to act in their several respective places when they cannot act: H. A. Walker and S. M. Lowrey, alternates to A. W. T. Bottomley; R. McCorriston and E. W. Carden, alternates to C. H. Cooke; F. C. Atherton and A. G. Budge, alternates to A. L. Castle.

Very truly yours,

HENRY WATERHOUSE  
TRUST COMPANY,  
LIMITED,

By /s/ W. F. FREAR,  
Its President.

By /s/ H. A. WHITE,  
Its Treasurer.

Approved:

BISHOP TRUST COMPANY,  
LIMITED,

By /s/ W. F. FREAR,  
Its President.

By /s/ E. W. SUTTON,  
Its Treasurer.

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

EXHIBIT J

(\$50,000.00)

February 21, 1931

For value received, the Henry Waterhouse Trust Company, Limited, promises to pay to American Factors, Limited, Fifty Thousand Dollars (\$50,000.00), with interest thereon from date at the rate of four per cent (4%) per annum, payment of principal and interest to be made only when, if and to the extent that there shall be funds available therefor as set forth in letter of this date from the payor to the payee.

HENRY WATERHOUSE  
TRUST COMPANY,  
LIMITED,

By /s/ W. F. FREAR,  
Its President.

By /s/ H. A. WHITE,  
Its Treasurer.

[Seal]



(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

EXHIBIT K

Henry Waterhouse Trust Company Balance Sheets

	As at 2/14/31 (Before Reor- ganization)	As at 2/14/31 (After Reor- ganization)
Assets:		
Cash .....	\$ 9,547.87	\$1,044,547.87
Investments .....	605,181.47	605,181.47
Receivables .....	77,184.34	77,184.34
Trust and agency accounts (Shingle & Campbell).....	733,914.08	.....
Other trust & agency accts.....	1,439,567.36	1,439,567.36
Loans .....	1,978,492.73	1,978,492.73
Other assets .....	75,117.15	75,117.15
Stocks and bonds.....	.....	.....
Stocks in subsidiaries.....	.....	.....
Advances to subsidiaries .....	.....	.....
Real estate for sale .....	.....	.....
Expense in suspense.....	.....	.....
Profit and loss—Special.....	.....	400,000.00
	<u>\$4,919,005.00</u>	<u>\$5,620,090.92</u>
Liabilities:		
Overdrafts balances due Brokers, etc.....	\$ 457,545.90	\$ 457,545.90
Notes payable .....	223,100.00	223,100.00
Trust & agency accounts.....	2,978,515.16	2,978,515.16
Loans pledged to clients.....	490,276.00	490,276.00
Merchandise accounts .....	.....	.....
Notes payable—affiliated Co. ....	.....	.....
Income in suspense.....	.....	.....
P. & L. Acct.—operating deficit 2/14/31 .....	.....	(10,149.29)
P. & L. Acct.—operating deficit subsequent to 2/14/31 .....	.....	.....
Surplus & surplus reserves.....	369,567.94	.....
Reserve for losses .....	.....	680,803.15
Contingent reserve—underwriters .....	.....	400,000.00
Capital stock .....	400,000.00	400,000.00
	<u>\$4,919,005.00</u>	<u>\$5,620,090.92</u>

(Testimony of Sherwood M. Lowrey.)

## Plaintiff's Exhibit P-11—(Continued)

## EXHIBIT L

## Henry Waterhouse Trust Company Balance Sheets

Assets:	As at 12/31/31	As at 12/31/32
Cash .....	\$ 29,700.69	\$ 14,639.50
Investments .....	.....	.....
Receivables .....	.....	15,214.69
Trust and agency accounts (Shingle & Campbell).....	.....	.....
Other trust & agency accts.....	383,460.67	299,565.32
Loans .....	2,247,844.14	1,624,740.12
Other assets .....	17,434.16	17,326.66
Stocks and bonds .....	251,220.65	267,122.42
Stocks in subsidiaries.....	303,704.16	303,704.16
Advances to subsidiaries.....	324,382.60	314,787.92
Real estate for sale.....	169,700.00	233,273.02
Expense in suspense.....	.....	17,500.00
Profit and Loss—Special.....	400,000.00	400,000.00
	<u>\$4,127,447.07</u>	<u>\$3,507,873.81</u>

## Liabilities:

Overdrafts balances due Brokers, etc.....	\$ 79,578.59	46,648.10
Notes payable .....	376,557.98	674,190.88
Trust & agency accounts.....	1,834,540.86	1,068,907.28
Loans pledged to clients.....	198,000.00	132,128.00
Merchandise accounts .....	1,252.11	.....
Notes payable—affiliated Co. ....	550,000.00	602,500.00
Income in suspense.....	.....	2,417.13
P. & L. Acct.—operating deficit 2/14/31	(10,149.29)	(10,149.29)
P. & L. Acct.—operating deficit subsequent to 2/14/31.....	(58,526.56)	(80,062.56)
Surplus & surplus reserves.....	.....	.....
Reserve for losses .....	356,193.38	271,294.27
Contingent reserve—Underwriters .....	400,000.00	400,000.00
Capital stock .....	400,000.00	400,000.00
	<u>\$4,127,447.07</u>	<u>\$3,507,873.81</u>

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

EXHIBIT M

Henry Waterhouse Trust Company  
Limited

P. O. Box 3410  
Honolulu, Hawaii

July 18, 1932

American Factors, Ltd.  
Honolulu, T. H.

Gentlemen:

Under date of February 21, 1931, you loaned to this Company the sum of \$50,000.00 for which we gave you our promissory note payable upon the terms and conditions set forth in our letter to you of like date.

On February 24, 1931, it was agreed that there should be an Advisory Committee representing your Company and the other corporations and/or individuals (hereinafter called the "Underwriters") who loaned to this Company an aggregate of \$400,000.00,—the duties of said Committee being to pass upon various matters of importance, particularly those which might affect the amount of reimbursement ultimately to be made to said Underwriters.

Early in 1932 the Advisory and Finance Committees of this Company decided that it was advisable to reappraise all of its assets; an exhaustive reappraisal disclosed that its liabilities, other

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

than those to the Underwriters and Stockholders, exceeded the value of its assets by a very considerable amount. Since that time market conditions have become worse. We are now quite confident, and accordingly advise you, that in our opinion the promissory note of \$50,000.00 above referred to is of no value whatever. Despite the worthlessness of the note it remains an apparent liability of this Company and operates as a hindrance to its speedy liquidation, especially as so long as it remains on our books the Advisory Committee will have to be continued. Hence we suggest that you concede the worthlessness of the note by formally authorizing this Company to consider that it is no longer an obligation. We have been informed that, under these circumstances, you may claim said bad debt as a deduction in your income tax return for 1932, provided you write it off your books during said year.

If the foregoing suggestion is approved by all of the "Underwriters" it will no longer be necessary to have an Advisory Committee and we therefore ask that such Committee be abrogated.

Very truly yours,

HENRY WATERHOUSE

TRUST CO., LTD.,

/s/ M. B. HENSHAW,

Vice-President.

MBH:M

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

EXHIBIT M

December 19, 1933

The Bishop Company, Ltd.,  
Honolulu, T. H.

Attention: Mr. George P. Rea,  
Executive Vice-President.

Gentlemen:

It is planned to merge the Guardian, Pacific and Henry Waterhouse trust companies into the Bishop Trust Co., Ltd., for purposes of economy and simplicity of financial structure, under the provisions of Act 169 of the Session Laws of 1931. This plan has been approved unanimously at meetings of the directors of the four companies, and will be submitted to their stockholders respectively at meetings to be held on the 28th instant with a view to completing the merger by the end of the year.

Referring to the notes given to you and others by the Henry Waterhouse Trust Co., Ltd., when that company was taken over by the Bishop Trust Co., Ltd., the payment of which was contingent as therein set forth, and referring also to the letters of the Henry Waterhouse Trust Co., Ltd., to you and such others accompanying those notes and setting forth the agreement entered into at that time;



(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

It is proposed (1), if the holders of said notes so desire, after the merger, to keep earmarked the assets and liabilities of the Henry Waterhouse Trust Co., Ltd., as well as accurate accounts of all amounts which the Bishop Trust Co., Ltd., shall have theretofore contributed, advanced or loaned to the Henry Waterhouse Trust Co., Ltd., or which it may thereafter contribute or advance toward meeting such liabilities, so as to protect the rights of such holders in case by any possibility there should ultimately be an excess of such assets over such liabilities plus or including such contributions, advances and loans made and to be made by the Bishop Trust Co. and interest thereon, although it now appears to have become certain that, mainly in consequence of the depression, there will be no such excess to apply on account of said notes; said agreement to continue to apply in respect of such assets, liabilities, contributions, advances and loans as if there were no merger except that item “(b) \$1,000 per month to the Bishop Trust Co., Ltd., for overhead or supervision” in paragraph 6 shall not be operative;

Or (2) that such holders, on the theory that such notes have become worthless and to avoid needless expense to the Bishop Trust Co., Ltd., signify their willingness that no such earmarking or accounts be kept after the merger.

A meeting will be held on Thursday, December

(Testimony of Sherwood M. Lowrey.)

Plaintiff's Exhibit P-11—(Continued)

21, 1933, at 2:30 P.M. in the Board Room of the Bishop Trust Building, at which time and place we shall be pleased to answer any and all questions and give you any information which you may desire respecting the above matters.

Thereafter we will appreciate it if you will inform us whether or not proposal (2) is acceptable to you or, if not, whether you approve of proposal (1).

Very truly yours,

HENRY WATERHOUSE  
TRUST CO., LIMITED,  
M. B. HENSHAW,  
Vice-President.

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Mr. Wild: Is it 11? I ask that it be received as Exhibit P-11 in evidence.

Mr. Atherton: Your Honor, the Government in the [194] stipulation at the end of paragraph 2—there is an objection as to the admissibility of the statements of fact contained in that paragraph made by the defendant; and paragraph 19 of the stipulation which appears on page 13, the defendant has also noted a specific objection to the admissibility in evidence.

The Court: What paragraph?

Mr. Atherton: Paragraph 19. That is the top of page 13. The defendant has noted specifically

(Testimony of Sherwood M. Lowrey.)

its objection to the admissibility in evidence of that exhibit. Otherwise, the stipulation——

The Court: Why is that objection not contained in the stipulation? Is your objection set out in the stipulation?

Mr. Atherton: Yes, it is set out in that paragraph, your Honor.

The Court: Whereabouts?

Mr. Atherton: Right after the first sentence. It reads, "The defendant objects to the admissibility in evidence of Exhibit M on the following grounds . . . "

The Court: Oh, yes. All right. We will take that up as we come to it. If you will speedily read that—if you don't read it, I will have to read it.

Mr. Wild: Well, your Honor, I want to read it, but may I start in with paragraph 26 in the stipulation, your Honor? And by that time I take it counsel will be here for the rest. [195] Paragraph 26.

The Court: Page 16?

Mr. Wild: Page 16. "During the calendar year 1932 taxpayer paid the total sum of \$4,063.33 to the following individuals in the amounts stated opposite their names." And then it gives the amounts. "Mrs. R. C. Walker, \$1,200.00; Minor children of John Fran, deceased, \$300.00; Minor children of W. Zablan, deceased, \$240.00; Mrs. Wm. Searby, \$1,800.00; Mrs. Luddecke, \$523.33."

(Testimony of Sherwood M. Lowrey.)

And giving the total of the above payments which were to widows and minor children of former employees of plaintiff.

“In its federal income tax return for the taxable year 1932 taxpayer deducted the above amounts as ordinary and necessary expenses in computing its taxable net income. The Commissioner of Internal Revenue in his first deficiency letter allowed the deduction and in his second deficiency letter disallowed the same.”

We have stipulated on that.

Q. (By Mr. Wild): Now, Mr. Lowrey, it was part of your duty as treasurer of American Factors, was it, to pass on these questions of pension payments?

A. As one of a group to pass on them, yes, before they were finally submitted to the board of directors.

Q. And were all of the pensions that were mentioned [196] by me submitted to the board of directors? A. They were.

Q. You mean all of those that I have just mentioned, they have been submitted to the board?

A. As far as I know that was the usual custom of doing it.

Q. And who determined the amount of these pensions?

A. Well, it depended—the final amount was determined or authorized by the board of directors. But in order that there could be something for the

(Testimony of Sherwood M. Lowrey.)

board of directors to act upon it was usually the department head that conferred with me about it and we in turn would then take and discuss it with the head of the business, reach a conclusion, and when we reached a conclusion we thereafter recommended it to the board of directors for action.

Q. And were there occasions when amounts of small pensions were passed by the officers of the company without a formal approval by the board?

A. I think so in those days. The list was none-too-great and some of the amounts were small. Anything that amounted to anything was submitted to the board.

Mr. Wild: I think I have given you copies of letters and so forth.

Mr. Atherton: You didn't give them to me.

Mr. Wild: I must say, your Honor, that I have been in a [197] great dither here because the Government hasn't made any copies of anything and I have tried to furnish them all. And if the Government can't find them and I can't find them, why, we were always in a to-do about it.

Mr. Atherton: I don't think those kind of remarks are appropriate, because, as a matter of fact, it seems as though he is trying to prejudice the Court against the Government.

Mr. Wild: Not at all.

Mr. Atherton: Now, counsel showed me copies of these letters in his office but he did not furnish them to me. I haven't any in my files.



(Testimony of Sherwood M. Lowrey.)

Mr. Wild: I'd be glad to turn them over to him. I am trying to cooperate with him in any way. As I say, some of them have been lost. Well, I will hand you some original certified copies of letters.

Mr. Atherton: I haven't got them. You may have thought so, but I haven't them.

Mr. Wild: I think I am clear out of them, your Honor. I just wanted to furnish copies, your Honor.

Q. (By Mr. Wild): I am showing you there an original or a copy, certified copy of a letter concerning payment to Mrs. Joseph K. Zablan. Do you have any recollection about that? (Showing a document to the witness.)

A. I know it goes 'way back. Zablan, her husband, [198] was in the employ of the company for many, many years. And from a notation that I had the chief accountant who keeps the records make on these letters, it said that Zablan worked for the company from 1899 to 1926, a period of 27 years. And then I do know that Mrs. Zablan, from information I gathered this morning, worked intermittently. Then she came on the payroll in 1928 and worked until 1933, a period of five years.

Q. And when was this pension for her approved?

The Court: It wasn't for her; for her minor children.

Q. Her minor children.

(Testimony of Sherwood M. Lowrey.)

A. In 1928 it appears to be.

Q. And what was the amount of that payment, if it shows there?

A. Ten dollars per month for each child.

Q. I see.

A. Beginning with the month of September '28 and continuing until further notice.

Q. And was that pension in force during the year 1932?

A. So far as I know. If it was shown on the account as a pension and a deduction for Federal taxation purposes, it would be indicated; it would be; it would have been.

Q. Well, it has been stipulated that that amount was paid to her.

A. Yes, and that is correct.

Q. And what was that pension paid on account of?

A. The faithful services that the father had rendered the company together with a smaller amount that the mother had rendered the company; and in order to help those children get through their schooling so that they could become independent and as citizens within the community.

Q. Now, is there a reference to minor children of John Frank, deceased there? It is stipulated that three hundred dollars was paid to or for the minor children of John Frank, deceased, in the amount of three hundred dollars.

A. I asked about John Frank from some of the old-timers, and there was action taken by the

(Testimony of Sherwood M. Lowrey.)

board in regard to that in November 27, 1922. John Frank was employed as one of the packers in the grocery packing room, open stockroom where the orders would be put up and gathered together. He worked for the company for a period of 25 years; payment of a pension up to one hundred dollars per month until further action of the board be authorized.

Q. And actually that was paid, there was paid three hundred in the year 1932 as per the stipulation. Now, Mrs. R. C. Walker, twelve hundred dollars.

A. Mrs. R. C. Walker was the wife of Clement C. Walker, R. Clement Walker, who was the first treasurer. He was an employee, a certified public accountant, as I remember, who was with Mr. Bottomley in the Bank of Bishop and [200] Company. At the time Mr. Bottomley came over to assume the head, presidency of American Factors, he brought over R. C. Walker as his treasurer. And he had the greatest of confidence in Mr. Walker on account of his capabilities and his qualifications, and Mr. Walker was treasurer of the company from the time it was organized in August there of 1918 until his death the early part of 1920. He had rendered very valuable service during that formation period getting the accounts of the two

(Testimony of Sherwood M. Lowrey.)

companies together, getting a system of accounting set up in order that it could be followed through and carried along.

Q. And was this payment made to his widow, Mrs. R. C. Walker?

A. Yes, when he died there were two little girls, and the board of directors authorized the payment of one hundred dollars a month to her which had been continued from year to year, and I think is still being paid to her.

Mr. Atherton: Your Honor, I must object to the witness testifying to what the board authorized. The best evidence of that is the action taken by the board of directors in the minutes. So I therefore move that his statement as to what the board did be stricken.

Q. (By Mr. Wild): Do you have a copy of the minutes?

A. I have. Do you wish it read? [201]

Q. Well, I'd like to—

Mr. Wild: Here again is this offer, this situation. I thought I furnished counsel with full copies of everything, and apparently I didn't. This is a certified copy from the record. I showed you a certified copy, I think, of the directors' resolution. You read that in my office.

Mr. Atherton: I saw something in your office. I remember the letters but I don't remember seeing the resolutions.

Mr. Wild: Well, do you have them there?

(Testimony of Sherwood M. Lowrey.)

Mr. Atherton: No, I don't have anything.

The Witness: Yes, I have a certified copy of the resolution.

The Court: I assume they will be offered in evidence.

Mr. Atherton: Yes. I would like to look at them.

Mr. Wild: May I just check through my records here again? I had honestly thought that——

The Court: Do that while counsel is examining the document. Those purport to be certified copies of the resolutions passed by the board of directors?

The Witness: Certified to by the secretary of the company.

The Court: They relate to these so-called pensions?

The Witness: This one we are now reading pertains to Mrs. Walker. [202]

The Court: The document shows that the resolution was adopted by the board of directors?

The Witness: The motion was seconded by Mr. Dowsett.

Mr. Wild: Well, I can't find any here.

The Witness: I have an extra set that you gave me.

Mr. Wild: I had six sets made besides the original.

The Witness: I'd like to have this one on account of the notations to refresh my memory.

Mr. Wild: Well, I'd like to offer the set of the



(Testimony of Sherwood M. Lowrey.)

letters and certified copies of the resolutions in evidence, your Honor.

Mr. Atherton: Now, your Honor, I doubt that there is any proper foundation for proffering this letter in evidence.

The Court: What is the letter that you speak of?

Mr. Atherton: The letter is addressed to Mr. Swift, the merchandising manager, and it purports to be signed by the assistant manager of the merchandise department.

Mr. Wild: Very well. I will go right ahead and put on more proof on it.

The Court: The letter inquiring as to the propriety of pensions to someone?

Mr. Atherton: No, it is a letter dated September 17, 1928, and says in substance that it attaches two letters addressed to the firm dated August 28 by Mr. Lemke, administrator of the estate of Joseph K. Zablan, deceased, and [203] a copy of a letter dated August 29th to the Social Service Bureau, and that bureau's reply thereto of September 13th. Then it goes on to tell Mr. Swift that this decedent had been an employee of the coffee department and that the writer of the letter had discussed the letter with Mr. Lemke, the administrator, and that he recommended for consideration of payment ten dollars a month for each child beginning in the month of September, 1928, continuing until further notice.

(Testimony of Sherwood M. Lowrey.)

The Court: Well, that was eventually carried out by the board of directors, was it?

Mr. Atherton: It was paid. The amount was paid, yes. I will withdraw my objection to the letter, any objection to the letter, and let it go in.

Mr. Wild: I think those, all those were done.

Mr. Atherton: I will withdraw any technical objection to the admissibility of this correspondence.

The Court: Received in evidence as Exhibit P-11.

Mr. Wild: No, 12. Can't all of them go in as P-12?

Mr. Atherton: Yes.

The Witness: Do you want this to go in?

Mr. Wild: No, I want the original to go in.

(The documents referred to were received in evidence as Plaintiff's Exhibit P-12.)

Mr. Wild: I honestly thought I had more copies.

Mr. Atherton: I know you did. Do you want to ask him [204] any more questions?

Mr. Wild: I was going to ask him seriatim about them.

Q. (By Mr. Wild): Now, the pensions to Mrs. William Searby of \$1,800. Who was Mrs. William Searby?

A. She was the wife of William Searby, who was a technical mill man. He worked for many years for the Baldwin interest in Maui at H. C. and

(Testimony of Sherwood M. Lowrey.)

S. and when American Factors was formed he was taken in to head up the mill engineering department of American Factors.

Q. And about when did he die?

A. I think he was with the company for about ten years.

Q. And were his services valuable or otherwise to the company?

A. His services were valuable for the reason that during the war years Hackfeld and Company had, so to speak, stripped their plantations a great deal in order to get as much money out of them as they possibly could so that dividends could be paid to the German shareholders so the German shareholders in turn could send money home. And the physical condition and the agricultural condition of the plantations were bad. Searby had a big job in trying to reestablish and building those plantations up.

Q. And what about Mrs. Lueddecke?

A. Mrs. Lueddecke was the wife of an elderly person [205] who was a watchman on the property. And he worked with the company for something, I think, a little over 25 years, 24 years, 1899 to 1923. In other words, with these old-timers who were kept on the payroll after American Factors took it over from Hackfeld, we recognized the services they had rendered to the predecessor, our predecessor, because, on account of there being a change in there it was no fault of those employees,

(Testimony of Sherwood M. Lowrey.)

and therefore, for the purposes of a pension or assistance in their old age to their families, we recognized the services that they had rendered. And on the basis that it was, so to speak, undisclosed liability, a moral liability, at least, when Factors having taken over Hackfeld and Company as a going concern, to do that which we considered was right towards those employees, their widows and children.

Q. And was it or wasn't it made on account of the value of past services rendered?

A. On account of the past services. That was all taken into consideration, what the man had done, how valuable his services had been to the company, and over what period of years.

Mr. Wild: No further questions on that issue.

### Cross-Examination

By Mr. Atherton:

Q. Mr. Lowrey, this Mr. Joseph K. Zablan, deceased, what compensation did the company pay him while he was alive and in the employ of the company? [206]

A. I cannot tell you. The records of the company would show, but it is a point that I never had anything to do with, making up the payrolls, and a lot of the minor employees I'd have little to do with the rate of compensation that was paid.

Q. Did you have anything to do with fixing the amount of the so-called pensions? A. I did.

(Testimony of Sherwood M. Lowrey.)

Q. What was the basis upon which you arrived at a payment of ten dollars a month for the support of each child of that deceased employee?

A. First of all we tried to find out what was left of the family. Having done that, we considered the length of service that the former employee had rendered the company, the length of service, how valuable that service was. And we would take into consideration the general picture of the family's condition and then try to do something which was well within reason to assist them over those critical periods when the youngster is trying to gain his education before he takes his position in life.

Q. Did the amount of the compensation, pension fixed by the company, bear any relationship to the compensation that the employee had received from the company prior to his death?

A. It did. In other words, a party who was receiving [207] a much higher salary, a higher standard plane upon which he was living, that would all be taken into consideration.

Q. Now, then, I think you testified that Mr. Walker, one of the officers of the company, was treasurer of the company.

A. He was my predecessor.

Q. Do you happen to recollect what his salary was as treasurer of the company?

A. I think it was ten thousand dollars a year.

Q. According to the minutes of the board of



(Testimony of Sherwood M. Lowrey.)

directors held on May 18, 1920, approving a monthly allowance to his family, that allowance was fixed at one hundred dollars. Was that supposed to represent additional compensation to Mr. Walker in any sense?

A. Different compensation paid to the family on account of the valuable service that he had rendered. It was not any great amount for the simple reason he hadn't been with the company any longer period of years. I think it was about 18, 20 months he was with us.

Mr. Wild: It's surprising to me that the Government would jump on the company for treating its employees that way.

Q. (By Mr. Atherton): Did the company have any pension plan?

A. A formal pension plan? [208]

Q. Yes.

A. No, we did not. Everything was considered along these lines on an informal basis.

Q. Well, the amounts of these so-called pensions were fixed for any stated periods of time or were they to continue at the pleasure of the board of directors?

A. I think you will notice some of those until further action by the board. In other words, they were more or less continuous but if circumstances came up whereby the management wished to make a recommendation for a change, it might be up on account of illness coming in or it might be down on account of a child having finished his schooling,

(Testimony of Sherwood M. Lowrey.)

or something like that; until further action of the board, then they kept on going. And it wasn't until latter years that the entire list was reviewed each year.

Mr. Atherton: I don't think I care to examine the witness any further on this particular issue.

The Court: Was it that you felt these employees had been underpaid during their lifetime and they should be paid something to their dependents after they were dead?

The Witness: I do not think that was the case. There was more or less in any community a going scale of wages which you have to meet if you are continuing in business. We met that. But in all cases, at least in a large number of cases, when disaster comes to a family, when the bread-winner has been knocked out, and in recognition of the faithful services rendered by these individuals the company felt obligated to take and assist those families until a readjustment could be made.

The Court: Well, was it regarded merely as a gift?

The Witness: No, sir, it was not, because it was in recognition of the services and what the services were and what the man had been paid, the number of years that he had been in service with the company, were all taken into consideration.

The Court: All right. That's all.

Mr. Wild: Might I ask one question there?

Q. (By Mr. Wild): Mr. Lowrey, you were

(Testimony of Sherwood M. Lowrey.)

treasurer of American Factors, Limited for the years '32, '33 and so on, and the years before?

A. Yes.

Q. And pensions to these very same people were always allowed by the Internal Revenue Department for those other years?

A. As far as I know.

Mr. Atherton: Your Honor, I move to strike that as being immaterial and irrelevant to the issue here.

Mr. Wild: They ruled on it again and again. And under that regulation which I cited to your Honor, the mere payment is sufficient to allow deductions.

The Court: I don't feel inclined to grant the motion [210] to strike.

Mr. Wild: Very well. Now, may it please the Court, we turn to the issue of the deduction of the Henry Waterhouse Trust Company note loss. Would it be to your Honor's pleasure that I read the stipulation first and then have Mr. Lowrey testify?

The Court: Does all the remainder of this stipulation run to that item?

Mr. Wild: Yes, your Honor, except the first paragraph, your Honor.

The Court: Yes, the first paragraph may be skipped.

Mr. Wild: May what?

The Court: You may omit the first paragraph.

Mr. Wild: Yes. "II. American Factors, Lim-

(Testimony of Sherwood M. Lowrey.)

ited, at the end of the calendar year 1930 had a capital of \$10,000,000.00, and its books showed a surplus and undivided profits of \$5,971,049.93 or a total capital and book surplus of \$15,971,049.93. At the end of the calendar year 1930, and during the entire calendar year 1931, American Factors, Limited, was agent for thirteen sugar plantations and other corporations located in and carrying on business in the Hawaiian Islands, which corporations, according to their books and annual reports, had a total capital of \$26,944,720.00 and a total surplus and undivided profits of \$21,411,420.24, or a total capital and surplus as of December 31, 1930, of \$48,356,140.24. On [211] December 30, 1930, American Factors, Limited, and the companies for which it served as agent had on deposit in the banks of the Territory of Hawaii at least a total sum of \$1,741,696.24. The Defendant objects to admissibility in evidence of the aforesaid facts on the ground of their immateriality and irrelevance."

The Court: Well, the purpose of that is to build up in what substance you can of the reason and purpose for making this contribution to save Henry Waterhouse Trust Company?

Mr. Wild: In part, your Honor. That's right. Only I don't call it a contribution. I say it is a loan.

The Court: For what other purpose than that?

Mr. Wild: Merely to bring this case within certain authorities dealing with the position of the company, you see, your Honor, but that is the

(Testimony of Sherwood M. Lowrey.)

ultimate, really the ultimate purpose. I really think that we could say the main purpose is to show the business reasons why American Factors, Limited would be willing to make a trifling loan for the purpose among others of safeguarding the financial interests of itself and its agents, especially where by making such a loan there was a reasonable and justifiable expectation of having it repaid.

The Court: Well, that is a matter of argument. I can see no prejudice to the Government in letting that come in evidence. Do you wish to reserve an exception? [212]

Mr. Atherton: No, your Honor. I won't reserve an exception to that.

The Court: Proceed, then.

Mr. Wild: "III. The Henry Waterhouse Trust Company, Limited (hereinafter called the Waterhouse Company), was incorporated under the laws of the Territory of Hawaii on November 26, 1902, to engage in the business usual and permitted to a trust company under the laws of the territory. In addition to engaging in the usual fiduciary business common to all trust companies, it operated a plantation agency department, a real estate department, a stock and bond brokerage department, and an insurance department, and at times invested in stocks and bonds to a limited extent on its own account, these various activities being permissible under the Hawaiian statutes."

The Court: No objection?

Mr. Atherton: No objection.



(Testimony of Sherwood M. Lowrey.)

Mr. Wild: "IV. In the middle of October, 1930, Waterhouse increased its capital stock from \$200,000 to \$400,000, consisting of 4,000 shares of a par value of \$100 each. The new shares were all taken by the old stockholders who paid for them in cash at par. In November the effects of the general business depression began to be felt in the Territory of Hawaii, and as a large part of the Waterhouse assets consisted of real estate and mortgages, its secretary became [213] apprehensive that if many calls were made on its demand accounts the Company's financial condition would not be sufficiently liquid to meet its cash requirements. He discussed the situation with the treasurer and auditor of Waterhouse and then advised the management of Bishop Trust Company, Limited, hereinafter called Bishop Trust, that a sale of the stock might be arranged, suggesting a price of \$100 each or more for the shares."

Mr. Atherton: No objection.

Mr. Wild: "V. An Audit Report dated March 31, 1931, signed H. C. Tennent and Co. by E. J. Greaney disclosed the book value of assets of the Waterhouse Company as of February 14, 1931, to be in the amount of \$4,820,090.92 and the liabilities, exclusive of capital and surplus, to be in the amount of \$4,149,437.06. This Audit Report contained the following statement:

" 'The Contingent Reserve (for losses) of \$680,803.15 and the Special Contingent Reserve of \$400,000.00 referred to above, are considered adequate

(Testimony of Sherwood M. Lowrey.)

to cover probable losses in the realization of the assets and liquidation of liabilities.'

"It is also stated in the Report that the principal purpose of the Audit was to establish as accurately as possible the total assets and liabilities as of February 14, 1931, the date control of the Company passed to the Bishop Trust Company, [214] Limited, through its acquiring all of the stock of the Waterhouse Company."

Mr. Atherton: No objection.

Mr. Wild: "It is also stated in the Report that Exhibit A attached thereto, a copy of which is hereunto annexed and made a part hereof as Exhibit A, shows the Capital and Surplus of the Waterhouse Company as of February 14, 1931, before adjustment, the total estimated losses finally agreed upon as acceptable to the Bishop Trust Company, Limited, and the manner of arriving at the Contingent Reserve (for losses) and the Special Contingent Reserve. In this connection, the Report states, by way of explanation of said Exhibit A, that the balance sheet shows the Profit and Loss account with a debit balance of \$400,000.00 offset against the Contingent Reserve (for losses); and that this appears as preferable for balance sheet purposes to the alternative of clearing the Capital Stock Account, and produces the same net result."

Mr. Atherton: No objection.

Mr. Wild: "By way of explanation of Exhibit D attached to the Report, it is stated that the Special Contingent Reserve, as shown in Exhibit A

(Testimony of Sherwood M. Lowrey.)

above, will remain intact until actual losses written off have fully exhausted the Contingent Reserve (for losses) of \$779,717.23; and that additional losses as determined will then be applied pro rata against the Special Contingent Reserve contributions." [215]

Mr. Atherton: No objection.

Mr. Wild: "VI. Mr. A. W. T. Bottomley, president of American Factors, Limited, and of the Bishop First National Bank of Honolulu and vice-president of the Bishop Trust Company, Limited, called a conference of the heads of the four Hawaiian sugar agencies, the president of the Bank of Hawaii, Limited, the president of the Hawaiian Trust Company, Limited, and two members of the finance committee of the Bishop Trust Company, Limited, to present to them the financial condition of the Waterhouse Company and discuss the feasibility of making some plan to prevent the Waterhouse Company from being forced into liquidation."

Mr. Atherton: No objection.

The Court: What Hawaiian sugar agency is referred to? Is that disclosed there?

Mr. Wild: It doesn't show. Alexander and Baldwin, Castle and Cooke, American Factors were three of them. They all came in and advanced money. The Government stated to me that that was accurate, and to my knowledge there had been only three of them, but I am willing to state that four—

(Testimony of Sherwood M. Lowrey.)

The Court: Brewer and Company, and Davies and Company?

Mr. Wild: No, they didn't come in. I have no information, your Honor. My information is that there were only three, and counsel for the government said it was only four. And I said I don't care. I will stipulate on his statement. [216]

"VII. The Waterhouse Company was conducting business as usual but was encountering some financial difficulties; economic conditions were not clear, and, after the investigation, the executives of the Bishop Trust Company, Limited, wished to look further into the matter before acting. After February 1, 1931, the Bishop Trust Company, Limited, advised the Waterhouse Company shareholders that it would not pay cash for their shares as had previously been suggested. On Saturday, February 14, 1931, Mr. W. F. Frear, president of the Bishop Trust Company, Limited, at a meeting of the board of directors of that company made a statement which was recorded on the minutes as follows:

'This is a special meeting called to consider a proposition to take over the Henry Waterhouse Trust Co., Ltd. At first it was a proposition to purchase the stock of that company, somewhat as we purchased the stock of the Pacific Trust Co., but as a result of investigation, it changed largely to a salvage proposition.

'The plan now is for our Company to acquire all the stock of the Waterhouse Trust Co. without cost; for Mr. and Mrs. R. W. Shingle and Mr. A. N.

(Testimony of Sherwood M. Lowrey.)

Campbell in settlement of their indebtedness to the Company, to pay into it \$535,000.00 and to convey to its order their respective 18% and 10% undivided interests in [217] certain land, fish ponds and fishery at Kalihi, the same to be sold for \$87,000.00 and the proceeds, with \$13,000.00 additional contributed by the Bishop Trust Co., to make up an even \$100,000.00, to be paid into the Waterhouse Trust Co., making in all \$635,000.00 thus paid in. In addition, a number of corporations and individuals are to contribute various sums aggregating \$400,000.00, thus making altogether \$1,035,000.00 of cash to be paid into the Waterhouse Trust Co. The Bishop Trust Co. is to pay such amount, if any, as may be required in addition to enable the Waterhouse Trust Company to meet its liabilities, but it is hoped that no such contribution will be required. That, however, remains to be seen.

‘The Bishop Trust Co. is to take over, without other cost, the business of the Waterhouse Trust Co., other than the assets and liabilities, and to operate such business at its own expense and for its own benefit. This will include the trusts, executorships, agencies, insurance, safe deposit business, etc., with the necessary furniture, equipment and supplies therefor. It is hoped also that the Bishop Trust Co., will profit through making new contacts. The stock and bond and real estate departments will probably be discontinued.

‘The assets and liabilities of the Waterhouse Trust [218] Co. are to be gradually liquidated by



(Testimony of Sherwood M. Lowrey.)

applying the assets to the liabilities, together with the expenses of liquidation, including \$1,000.00 a month to be paid to the Bishop Trust Co. for supervision.

‘In final settlement, if there is an excess of assets over liabilities, it is to be applied, first, to the reimbursement of the amount, if any, that may be contributed by the Bishop Trust Co. in addition to the \$1,035,000.00, and, secondly, pro rata to the contributors of the \$400,000.00 with simple interest at 4%, and, thirdly, the balance, if any, to go to the Bishop Trust Co.

‘There are three objects: First, to prevent the failure of such a company as the Waterhouse Trust Co., with the consequent general disastrous effects; secondly, to prevent loss on the part of many who have entrusted their money to the Company for investment and who can ill afford the loss; and, thirdly, to enable the Bishop Trust Co. to acquire new business. These three objects naturally appeal with different degrees of force to different groups of contributors.’

The plan, as outlined, was approved by the Board of Directors of the Bishop Trust Company, Limited, at that meeting. The transactions mentioned in the second paragraph of Mr. Frear’s statement, *supra*, were duly performed within a [219] few days after February 14, 1931.”

Mr. Atherton: No objection.

Mr. Wild: “VIII. Prior to the consummation of the transactions hereinbefore mentioned, the fol-

(Testimony of Sherwood M. Lowrey.)

lowing individuals and corporations promised to pay to the Waterhouse Company, upon consummation of the proposed plan, the sums of money set opposite their names, to wit:

Name of Contributor	Amount Paid
The Bishop Company, Limited . . . . .	\$100,000
American Factors, Limited . . . . .	50,000
Alexander & Baldwin, Limited . . . . .	50,000
Castle & Cooke, Limited . . . . .	50,000
W. R. Castle . . . . .	50,000
Beatrice Castle Newcomb . . . . .	50,000
Bank of Hawaii . . . . .	25,000
Hawaiian Trust Company, Limited . . . .	25,000
<hr/>	
Total . . . . .	\$400,000''

Mr. Atherton: No objection.

Mr. Wild: "IX. Annexed hereto as Exhibit B and made a part hereof is an excerpt from the minutes of the meeting of the Board of Directors of American Factors, Limited, held on March 2, 1931, authorizing the aforesaid payment of \$50,000 to the Waterhouse Company. There are also annexed hereto and made a part hereof as Exhibits C, D, E, F and G, excerpts from the minutes of the Directors' meetings of the corporations who made their respective payments to the aforesaid \$400,000 fund of the Waterhouse Company."

Mr. Atherton: No objection.

Mr. Wild: "X. The plan of reorganization of

(Testimony of Sherwood M. Lowrey.)

the [220] Waterhouse Company was carried out as outlined above, and the individuals and corporations whose names appear in the preceding paragraph of this stipulation actually paid into the Waterhouse Company the amounts of money stated opposite their respective names upon the provisions concerning the repayment thereof as more particularly stated in the letters to Plaintiff dated February 21, 1931, and February 24, 1931, copies of which are attached hereto and made a part hereof as Exhibits H and I, respectively. Letters identical in form as Exhibits H and I were addressed to each of the individuals and corporations that made payments to the Waterhouse Company aggregating \$400,000, and said letters were duly received by each such individual and corporation."

Mr. Atherton: No objection.

Mr. Wild: "XI. Attached hereto and made a part hereof for all purposes and marked Exhibit J is a true copy of a promissory note executed and delivered by the Waterhouse Company to Plaintiff in the principal sum of \$50,000.00, being the note referred to in said letter, Exhibit H. Notes identical in form were executed and delivered by the Waterhouse Company to each such other corporation and to each such individual, which said notes were in each instance for the principal sum of money as stated opposite the name of the respective individuals and corporations hereinbefore stated."

Mr. Atherton: With respect to that paragraph, your Honor, [221] I would like to delete the word

(Testimony of Sherwood M. Lowrey.)

“promissory” before “note.” I don’t wish to accede on the part of the Government that that was really a promissory note.

Mr. Wild: This has already been signed up, your Honor, subject merely to objection, not as to the meat. I submit, your Honor, that we have already signed this stipulation. It was never requested—as a matter of fact, the great bulk of this the Government asked for, and it is already signed up.

Mr. Atherton: It hasn’t been filed.

Mr. Wild: I have offered it in evidence.

Mr. Atherton: It hasn’t been filed yet. True enough, a great many of the statements made here were suggested by the Government——

The Court: You wish to set out that this is a promissory note in a technical sense? The note reads, for value received Waterhouse Trust promises to pay.

Mr. Atherton: It is a conditional promise to pay.

The Court: It is conditional, no doubt about that.

Mr. Atherton: I don’t want any admission that that is a promissory note to preclude the Government from being paid.

The Court: Well, the note is referred to as Exhibit J. Call it what you want here. The note speaks for itself. I don’t think it is an admission on the part of the Government in signing this stipulation that it is in all strict technical respects a promissory note. [222]

Mr. Atherton: That’s all. I want to save an

(Testimony of Sherwood M. Lowrey.)

objection, so I'd like the record to show that.

The Court: Well, that might have been noticed before, that it is a conditional note. Go ahead.

Mr. Wild: "XII. The actual owners of the capital stock of the Waterhouse Company on February 14, 1931, shortly prior to the transfer of the stock of that company to the Bishop Trust Company, Limited, were as follows:

Stockholder	Shares	Par Value
A. N. Campbell .....	1,235	\$123,500.00
R. W. Shingle .....	1,235	123,500.00
A. L. Castle .....	700	70,000.00
J. K. Clarke .....	480	48,000.00
Harriet E. Wight .....	100	10,000.00
C. L. Wight .....	100	10,000.00
Marietta Withington .....	50	5,000.00
Arthur Withington .....	50	5,000.00
Estate of E. M. Lewis .....	50	5,000.00
<hr/>		<hr/>
Total .....	4,000	\$400,000.00"

Mr. Atherton: No objection.

Mr. Wild: "XIII. The four stockholders whose names appear first on the above list, namely, A. N. Campbell, R. W. Shingle, A. L. Castle and J. K. Clarke, were directors of the Waterhouse Company. Mr. W. R. Castle, father of A. L. Castle, purchased from the stockholders, other than Messrs. Campbell,



(Testimony of Sherwood M. Lowrey.)

Shingle and Clarke, their shares of the capital stock of the Waterhouse Company as follows:

Stockholder	Shares	Par Value
Harriet E. Wight .....	100	\$10,000.00
Charles L. Wight .....	100	10,000.00
Marietta Withington .....	50	5,000.00
Arthur Withington .....	50	5,000.00
Estate of E. M. Lewis .....	50	5,000.00
<hr/>		<hr/>
Total .....	350	\$35,000.00

Thus, on February 14, 1931, the following persons were the stockholders of the Waterhouse Company, and they were the owners of the number of shares shown opposite their names, to wit:

Stockholder	Shares	Par Value
A. N. Campbell .....	1,235	\$123,500.00
R. W. Shingle .....	1,235	123,500.00
A. L. Castle .....	700	70,000.00
W. R. Castle .....	350	35,000.00
J. K. Clarke .....	480	48,000.00
<hr/>		<hr/>
Total .....	4,000	\$400,000.00''

Mr. Atherton: No objection.

Mr. Wild: "XIV. The \$400,000 par value of capital stock of the Waterhouse Company was transferred by the aforesaid stockholders to the Bishop Trust Company, Limited, as of February 14, 1931, and the cash balances, properties, stocks and bonds,

(Testimony of Sherwood M. Lowrey.)

accounts, books and records of the Waterhouse Company came under the management and control of the new stockholder, the Bishop Trust Company, Limited. New officers and directors were elected, a finance committee, comprised of officers and directors, and an advisory committee comprised of representatives of the \$400,000 noteholders, were appointed, and work was immediately commenced on the liquidation of the [224] Waterhouse Company.”

Mr. Atherton: No objection.

Mr. Wild: “XV. There is annexed hereto as Exhibit K and made a part hereof condensed balance sheets of the Waterhouse Company as at February 14, 1931, before and after the reorganization.”

Mr. Atherton: No objection.

Mr. Wild: “XVI. On May 29, 1931, the vice-president and manager of the Bishop Trust Company, Limited, who was also a director of the Waterhouse Company, stated to the board of directors of the Bishop Trust Company, Limited, that the operation of the Waterhouse Company business was causing a monthly loss ‘as it is in the nature of a receivership.’ He added the belief that ‘the bulk of the work in straightening out the affairs of the company will be accomplished within a year or two.’ At a meeting of June 26, 1931, he advised the board of directors of the Bishop Trust Company, Limited, that:

“\* \* \* he had made a recommendation to the Bishop Trust Company of a transfer of all of the work of the Waterhouse Trust Company directly

(Testimony of Sherwood M. Lowrey.)

to the Bishop Trust Company, with the exception of the collection agency end of the business.'

At the same time he stated his belief that the Bishop Trust Company, Limited, would suffer no loss if business should [225] again become normal. Thereupon the Bishop Trust Company, Limited, took over some of the Waterhouse Company business, but the Waterhouse Company continued to do some business until it, the Guardian Trust Company, Limited, and the Pacific Trust Company, Limited, were formally merged into the Bishop Trust Company, Limited, on December 30, 1933 as hereinafter set forth."

Mr. Atherton: No objection.

The Court: Who was that officer?

Mr. Wild: I think that was M. B. Henshaw, who is at present absent on the mainland, your Honor.

The Court: No objection?

Mr. Atherton: No objection.

Mr. Wild: Does your Honor want to take a short recess?

The Court: Yes, I will be glad to.

Mr. Wild: I think this is a convenient point.

(A short recess was taken at 3:00 p.m.)

#### After Recess

Mr. Wild: "XVII. There is annexed hereto as Exhibit L and made a part hereof condensed balance sheets of the Waterhouse Company as at December 31, 1931, and December 31, 1932."

Mr. Atherton: No objection.

Mr. Wild: "XVIII. The advisory committee referred to in Exhibit I was composed of prominent business and professional men who represented the aforesaid note holders who had made [226] payments into the aforesaid \$400,000.00 fund. The original committee consisted of:

1. A. W. T. Bottomley (now deceased) whose alternates were S. M. Lowrey, who was then Plaintiff's treasurer, and H. A. Walker who is now president of the Plaintiff.

2. C. H. Cooke, then president of the Bank of Hawaii, Limited, whose alternates were R. McCarrison, now a vice-president of the Bank of Hawaii, Limited, G. G. Fuller, now retired, who was a vice-president of the Bank of Hawaii until his retirement, and E. W. Carden who is now president of the Bank of Hawaii.

3. A. L. Castle, an attorney at law, at present a partner in the firm of Robertson, Castle & Anthony, whose alternates were F. C. Atherton (now deceased) then the president of Castle & Cooke, Limited, and A. G. Budge, now president of Castle & Cooke, Limited.

The composition of the advisory committee changed from time to time thereafter and among the other persons who attended meetings as a member of the committee was: James L. Cockburn who was then the executive vice-president of Bishop & Company, Limited.

This committee met frequently with the finance

committee of the Waterhouse Company and passed upon all matters of importance affecting that Company and particularly those matters tending to affect the amount of reimbursement, if any, [227] ultimately to be made to the special note holders. It advised with Bishop Trust Company, Limited, and its members were consulted from time to time by the Plaintiff and other special note holders."

Mr. Atherton: No objection.

Mr. Wild: "XIX. Under date of July 18, 1932, the Waterhouse Company, over the signature of M. B. Henshaw, vice-president, dispatched to the Plaintiff a letter, a true copy of which is annexed hereto as Exhibit M and made a part hereof. The defendant objects to the admissibility in evidence of Exhibit M on the following grounds."

Maybe you want to read them. Or shall I?

Mr. Atherton: You go ahead.

Mr. Wild: "Viz: (a) that the statements made therein are immaterial to any issue involved herein; and (b) that its admission in evidence for the purpose of proving the truth and accuracy of the statements made therein concerning the reappraisal of the assets and liabilities of the Waterhouse Co., and the competency and accuracy of such reappraisal would constitute a violation of the hearsay rule, and such evidence is also incompetent."

Now, that is the objection to that letter. Now, the rest of it is not a part of the objection. It reads:

"Letters identical in form to Exhibit M were dispatched by the Waterhouse Company to the other



note holders and [228] received by them. The advisory committee was not abrogated but continued to function as usual during the balance of the year 1932 and the year 1933."

The Court: What is that exhibit?

Mr. Wild: Exhibit M. Exhibit M is the letter of July 18, 1932. Shall I read it to your Honor off the record?

The Court: Yes.

(Exhibit M, letter dated July 18, 1932, from Henry Waterhouse Trust Co. to American Factors, Ltd. was read by Mr. Wild.)

The Court: What is the objection?

Mr. Atherton: The objection to that exhibit and all the other ones that are copies thereof addressed to the other note holders is that the statements made therein are immaterial to any issue involved in this litigation; that its admission in evidence for the purpose of proving the truth and accuracy of the statements made therein concerning the reappraisal of the assets and liabilities of the Waterhouse Company, and the competency and accuracy of such reappraisal, would constitute a violation of the hearsay rule, and such evidence is also incompetent.

The Court: Yes, but as I see it, these note holders did get such letter from the vice-president of the Waterhouse Company. It was argumentative but they threw up the sponge. Whether it had any influence on them collectively or individually, [229] I don't know. But they did receive such a letter.

Whether it is true or whether the letter is true or false in its statements——

Mr. Atherton: I am not objecting to the fact that they received such a letter and that the letter requested them to concede the worthlessness of the note, but I am objecting to the admissibility of the letter for the purpose of showing that there was any justification or any reasonable ground for determining the note to be worthless in 1932. Now, it could be admitted for a limited purpose.

The Court: The letter certainly doesn't admit the evidence that the note was worthless beyond an argumentative assertion of the vice-president of this company who wanted to get rid of the note, and urged it upon the note holders.

Mr. Atherton: Well, then, all my objection is, is that it might be admissible for the limited purpose of showing that he addressed the note holders such a letter and in that letter he asked them to concede the worthlessness of the note, but all other statements in there must not be taken as having been true.

The Court: As true. Well, that follows. They can't be taken as true; just merely that Mr. Henshaw wrote that.

Mr. Atherton: Well, I want to be sure.

The Court: I think that is understood by counsel and the Court. [230]

Mr. Wild: Why, yes, your Honor. This is part of the *Res gestae*, just like the other letter.

The Court: It couldn't be argued in the case

that because Mr. Henshaw made these statements for the purpose of urging the cancelling of the notes that all of his statements were true, or any of them are true for that matter.

Mr. Wild: Well, as I take it, the letter was evidence of what was stated there.

The Court: That's right.

Mr. Wild: And it doesn't go any beyond that.

The Court: It is not evidence of the truthfulness of the statements.

Mr. Wild: No, that's right. I will agree with that, your Honor, heartily.

The Court: Well, we may go on with the objection noted.

Mr. Wild: "XX. During 1933 for the stated purpose of simplifying its financial structure and effecting economies, Bishop Trust Company, Limited, decided to effect a merger. Attached hereto, made a part hereof for every purpose, and marked Exhibit N is a copy of a letter dated December 19, 1933, sent by the Waterhouse Company to The Bishop Company, Limited. Letters identical in form with Exhibit N were sent to and received by each of the aforesaid Waterhouse Company note holders."

Mr. Atherton: No objection. [231]

Mr. Wild: That is something he replies on the same thing as true there. Would it please your Honor if I would read the exhibits as we went along?

The Court: That is Exhibit N? That is another letter?

Mr. Wild: Yes, your Honor. I have omitted the exhibits because I thought we would read them as we went along after we had read the others, but we might as well read these.

The Court: The letter to George P. Rea, the executive officer of the Bishop Company. Is that Bishop Trust Company or Bishop what?

Mr. Wild: May I say there has been a slip here. There was a similar letter written to everybody. There is one written to American Factors. Exhibit N was supposed to be the letter addressed to American Factors, you see, but through error they copied the wrong one. It makes no difference because the same type of letter was sent to American Factors, and it says——

The Court: Is that conceded?

Mr. Atherton: That is conceded.

The Court: Now, I don't think it is necessary for you to take the time to read this unless there is some very different material in it. It is written by Henshaw, and he was making a further argument, was he, to just cancel the note?

Mr. Wild: Yes. The purpose of this is that the Government [232] wants to show by it, your Honor, that on December 29, '33, which is long after the year '32, that Henshaw asked the note holders to agree to surrender their notes then and call them worthless and release the committee. And then there is in the stipulation the statement of what was done

after that. Now, technically none of that stuff should go in the record because it is after the particular year. But I haven't any objection in entrusting it to your Honor. You see, there were two alternatives in the letter. They propose—the Bishop Trust was about to merge the Henry Waterhouse Trust and the others, and they wanted to terminate this committee and have the note owners concede that it was worthless and not have to set it up.

The Court: Well, he started out on that. They did.

Mr. Wild: In '32.

The Court: In July '32?

Mr. Wild: That's right.

The Court: And apparently it wasn't responded to.

Mr. Wild: That's right. They all didn't turn in. Now, the next paragraph is 21.

“On December 21, 1933, a meeting of the said Waterhouse Company noteholders was held at which the holders of \$300,000 out of a total of \$400,000 of the notes outstanding were represented as follows:

Noteholder	Amount of Note Held
American Factors, Ltd., S. M. Lowrey, representative .....	\$ 50,000
Alexander & Baldwin, Ltd., C. R. Linden, representative .....	50,000
The Bishop Company, Ltd., George P. Rea, representative .....	100,000



W. R. Castle, Alfred L. Castle representative .....	50,000
Alfred L. Castle, as executor under will of Beatrice Castle Newcomb, deceased, Alfred L. Castle, representative .....	50,000
	<hr/>
Total .....	\$300,000

The noteholders who were not represented at this meeting were:

Noteholder	Amount of Note
Castle & Cooke, Ltd. ....	\$ 50,000
Bank of Hawaii .....	25,000
Hawaiian Trust Co., Ltd. ....	25,000
	<hr/>
Total .....	\$100,000

Present by invitation were Messrs C. F. Weeber and M. B. Henshaw. The minutes of the meeting record that—

‘Mr. Henshaw stated that the purpose of the meeting was to consider the letters dated December 19 which had been sent out to all of the corporations and/or individuals who had loaned money to Henry Waterhouse Trust Co., Ltd., in February, 1931.’

And after some discussion it was the unanimous opinion of those present that proposal No. 1 as set forth in the letters dated December 19, 1933 (Exhibit N), be approved.

The minutes of that meeting also record that—

‘Mr. Linden suggested that after the proposed

merger the Advisory Committee be continued, at least until such time as the question of whether the notes held by [234] the underwriters become a loss in the year 1932, is definitely settled. It was the consensus of opinion that this suggestion be followed.' "

Mr. Atherton: No objection, your Honor.

Mr. Wild: May it please the Court, we take the position in regard to that paragraph that it is wholly immaterial what was done after. The Government wants it in. All right.

Mr. Atherton: With respect to paragraph 20, I don't know whether the record shows that the Government interposed no objection to that.

Mr. Wild: I think it shows. But if it doesn't, I am not interposing—

The Court: I have a note, "No objection."

Mr. Atherton: I just wanted to be sure. I didn't recall after the discussion.

Mr. Wild: "XXII. Following the merger aforesaid, on December 30, 1933, the Bishop Trust Company, Limited, for the purpose of accounting to the aforesaid noteholders kept separate accounting records referred to as the 'Waterhouse Section,' of the Waterhouse Company assets acquired and the liabilities assumed in respect thereto. Among the records so kept, a special account designated 'Notes Payable—Underwriters H W T—New' was set up to cover the \$400,000 paid in by the aforesaid noteholders and the charges against it. This account at

December 30, 1933, showed a credit balance of [235] \$400,000."

Mr. Atherton: No objection.

Mr. Wild: "XXIII. The following is a statement of book value of the Waterhouse Company assets, exclusive of cash, on the indicated dates, actual losses sustained on liquidation to the indicated dates, set up on the latter's books, and the estimated losses on liquidation arrived at by a group of officers of the Bishop Trust Company, Limited: Book value of assets exclusive of cash, actual losses sustained on liquidation, estimated loss on liquidation. February 14, 1931, the book value of assets, exclusive of cash, is \$4,275,543.05, and no losses sustained on liquidation. December 31, 1931, \$3,697,-746.38 of assets other than cash. Actual losses sustained on liquidation that year, \$324,913.77. In 1932, book value of assets exclusive of cash, \$2,993,234.31. Actual losses sustained on liquidation, \$410,345.80."

The Court: Those were accumulative losses?

Mr. Wild: Accumulative. That is, in other words, at December 31, '32, the actual losses sustained on realization of assets was a total of \$410,-345.80, not to be added together, as we stated above. And then, at the end of '33 there were \$2,965,675.99 worth of assets, and the actual losses sustained on liquidation at the end of 1933, accumulative, is only \$571,482.80. And estimated losses on liquidation had then been reduced to \$936,352.98.

Mr. Atherton: No objection.

Mr. Wild: They estimate much less loss on

actual liquidation at the end of '33 than they did in '31. No question about that.

The Court: Well, at the end of '33, with the total reserve, including the money raised from these funds, the issue of notes, they had a fund available to meet the liquidation and losses of \$1,080,803?

Mr. Wild: Yes, Your Honor, that's right. In other words, the book shows——

The Court: At the end of '33 they exhausted it or——

Mr. Wild: That's right.

The Court: ——still some value?

Mr. Wild: Above those of the notes.

The Court: Yes, something that appeared to be available in application against the payment of the notes?

Mr. Wild: Well, at that time they didn't need—at the end of '33, Your Honor, on actual liquidations they hadn't used up any of the money on those notes. They hadn't even gotten to it, because they had a \$700,000 capital and surplus item that had to come out first. There were still some three hundred thousand dollars.

The Court: Available?

Mr. Wild: Available before they had to touch the note [237] surplus. That's what this account shows, Your Honor, without any question.

The Court: At the end of '33?

Mr. Wild: At the end of '33. That is, on the actual liquidation of assets with the reserve set-up, with the surplus that had to be eaten up for three-

quarters of a million first. They had only eaten up of that three-quarters of a million \$400,000. They still had four hundred thousand to go before they hit the notes.

“XXIV. Plaintiff’s books of account were kept on the accrual basis of accounting, and, during the calendar years 1924-1932, inclusive, they were so kept, and its Federal Income Tax returns for those years made on that basis of accounting. In the calendar year 1932, Plaintiff charged off on its books of account the face amount of the aforesaid \$50,000.00 Waterhouse Trust Company promissory note which was given to the Plaintiff in the year 1931, pursuant to the actual method of charging off bad debts which the plaintiff used in that taxable year and all prior taxable years for income tax purposes.”

Mr. Atherton: Now, Your Honor, first there is apparently a typographical error here, the omission of the word “were” before the word “made” on the fourth line down in that paragraph. “Were made” it should be, I think.

Mr. Wild: That is right. There is a typo there.

The Court: Federal tax returns for those years “were made?”

Mr. Wild: I think I read it “were made.” But the word is omitted. May that be corrected?

Mr. Atherton: The Government would also like to delete from that paragraph the word “promissory” before the word “note” which appears on the seventh line down.

The Court: “. . . the aforesaid \$50,000.00 Water-



house Trust Company promissory note . . .” Well, may there be an understanding that that note wasn’t strictly a promissory note but had condition attached to it?

Mr. Wild: Well, your Honor, there is no doubt that it had conditions attached to it, but it was a promissory note nevertheless.

The Court: Promise to pay.

Mr. Wild: And as counsel has already stipulated, much of this stuff is his own language. As a matter of fact, I didn’t have any of this in. Well, I will put it in. Now he is objecting. I say it has already been signed and it is too late to object to it.

Mr. Atherton: No, it is not too late.

Mr. Wild: The Court had the note before it and it can characterize it for itself.

Mr. Atherton: It is not too late to have it deleted. It hasn’t been filed yet. [239]

Mr. Wild: Well, I have offered it all in evidence, and it has all been signed by counsel.

Mr. Atherton: But if your Honor will look at Exhibit H, in that letter of February 21, 1931, addressed to American Factors, it doesn’t characterize the note as a promissory note. And in the Government’s interest, I must protect my client’s interest, and that same objection obtains with respect to the preceding paragraph number.

The Court: Whenever it appears?

Mr. Atherton: Whenever it appears.

Mr. Wild: Now I don’t know. I may want to strike this all out. I had in my request one stipula-

tion, one paragraph on the Henry Waterhouse Trust. Government counsel wrote up all this long linguist stuff; he took it from the two prior cases which I tried in part and put it in, and that is his own language. Now, we signed it up in good faith, and I told him I'd make no objection. Now he comes along and wants to change the language. I think a good bit of it is wholly immaterial myself. But your Honor is going to refer to the note itself, and no matter how we characterize it, your Honor is going to hold it.

The Court: The note speaks for itself; that is, the note that is referred to there as Exhibit N, is it?

Mr. Wild: Yes, your Honor.

The Court: I see no prejudice in it. [240]

Mr. Wild: The note isn't handy.

The Court: There is a copy of the note in here some place. I just referred to it awhile ago.

Mr. Wild: It isn't in but it is there. Is it J? It is J. No.

Mr. Atherton: J, is it not?

Mr. Wild: J, yes, your Honor, Exhibit J. Now, are we ready to proceed, your Honor?

The Court: Yes.

Mr. Wild: "XXV. In its Federal Income Tax return for the taxable year 1932, at item 20 on page 1 thereof, the taxpayer took as a bad debt deduction the entire amount of \$50,000 paid by it to the Waterhouse Company in 1931. The Commissioner of Internal Revenue determined that the \$50,000 paid to

Henry Waterhouse Trust Company was not deductible as a bad debt deduction for the year 1932."

Mr. Atherton: No objection.

Mr. Wild: Now, we have read 26, your Honor, and that is the last paragraph. May I put Mr. Lowrey on the stand?

The Court: Yes.

### SHERWOOD M. LOWREY

recalled and testified further as follows:

#### Direct Examination

By Mr. Wild:

Q. Mr. Lowrey, you have already been sworn in this [241] matter, and just to briefly summarize, during the calendar year 1931 and '32 you were the treasurer of American Factors, Limited, plaintiff in this cause? A. I was.

Q. As such treasurer what, if anything, did you have to do with a certain promissory note dated February 21, 1931, in the amount of \$50,000, a true copy of which is Exhibit J annexed to stipulation or Exhibit P-11? What did you have to do with that?

A. Well, first of all the note was—Mr. Bottomley, the manager of the concern, the company, after consultation with several others, worked up a plan whereby financial aid was to be given the Waterhouse Trust Company. As has been set forth in the stipulation just read, the Waterhouse Company was short of cash. At least, that is the gist

(Testimony of Sherwood M. Lowrey.)

of it. It had lots of assets but they were short of cash. They brought more cash in with the issuance of capital stock. Further cash was necessary to put them in a more liquid condition. And a group already named agreed to loan them a certain amount of money.

Mr. Atherton: Your Honor, excuse me, please, but I think the witness' answer is beyond the scope of the question.

Mr. Wild: I am just asking him what he knew about this note, what he knew about the transaction.

The Court: Well, I guess he is up to the point now of [242] telling.

A. (Continuing): Mr. Bottomley agreed with certain of the directors of his own company that it would be proper for American Factors to loan Waterhouse Trust Company \$50,000, taking therefor a note in such form as has been submitted to this Court. The loan was made to Waterhouse Trust Company. He presented the matter to me. I authorized the issuance of the check. The loan was made. The note was received. And later on the action was confirmed by the board of directors of American Factors, Limited. That was in the early part of 1931.

Q. Now, at that time, did Mr. Bottomley make any statement to you as treasurer of American Factors, Limited, during your presence concerning the possibility of collecting anything on that note?

(Testimony of Sherwood M. Lowrey.)

A. Yes, he told me that Waterhouse Trust Company—and that was the reason I made those preliminary remarks—that they were short of cash, and it was felt by the business interests in the community, so-called leading business interests, that it might be a very disastrous thing to the community as a whole should Waterhouse Trust Company fail. And, therefore, a group had gotten together to try and finance them themselves, the stockholders showing their good faith by doubling their capital and outside interests putting up the \$400,000 as has been mentioned. And it was hoped with that [243] financial assistance the Waterhouse Trust Company could, so to speak, weather the storm. We were going through our depression here, which always came later than the depression on the mainland. It has been customary here for years. We were going into the depression; we were in it. It was felt with this financial assistance the company could go ahead.

The Court: Well, I think that is beyond the scope of the question.

Q. Well, did Mr. Bottomley make any statement as to whether or not American Factors had any possibility of repayment under this note?

A. Yes, he thought that by the assistance thus granted.

Q. State what he told them.

A. He stated that it was in his opinion that by granting this assistance to Waterhouse Trust Com-



(Testimony of Sherwood M. Lowrey.)

pany they'd weather the storm and the money would be repaid.

Q. And did you review that note again during the calendar year 1931?

A. Yes. That was one of the things with which I was charged with. Each year it was a question of reviewing the accounts and notes receivable that the company owned. It was a practice to either take and write off any accounts or notes that became valueless in a certain year or else it was a question of creating a reserve in order that the balance sheet might take and show what was considered a proper asset [244] for the receivables. We considered the Waterhouse Trust Company and at the end of 1931 it was felt that the note was good and no reserve was created.

Q. Was it a part of your duty always as treasurer of American Factors, Limited, to review each year all of the receivables that were owned by the company?

A. Yes, with the assistance of the department heads. In other words, I had them prepare a list of those which in their opinion needed to be reviewed and looked into. If the accounts were perfectly all right in their opinion, they were not reviewed. Only those which were considered to be in a questionable class. If they were bad, they were written off. If there was some question or that we had not used every means of collecting them, a reserve was created. But the reserves were never

(Testimony of Sherwood M. Lowrey.)

taken into consideration in determining a taxable liability; merely for balancing purposes.

Q. And it was in connection with this regular examination of yours that you had made every year since you were treasurer?

A. Customary procedure.

Q. That you examined the Waterhouse Trust Company note in 1931?      A. Yes.

Q. Now, did you as treasurer receive or see that certain letter referred to, a copy of which is annexed to the [245] complaint, I think as—not the complaint—Exhibit P-11, as Exhibit M?

A. I did.

Q. And I will show you—I have already showed counsel—the original of that letter, the original of the note, and ask you just to examine it. Did you ever see that exhibit before?

A. Comprising both documents?

Q. No, just the letter of July 18th.

A. Yes, I have.

Q. And what did you do after receiving or reading that letter?

A. Well, at that time there was this advisory committee, and, as has been shown in the stipulation, I was Mr. Bottomley's alternate or one of these alternates on that, and I attended certain meetings in his absence. I knew what the procedure the committee followed, in determining the value of the assets, and the procedure which they had adopted in gradually liquidating their assets.

(Testimony of Sherwood M. Lowrey.)

Q. Did you make any inquiry after receiving that letter?

A. After receiving this letter, knowing something about it already from my work on the advisory committee, I went into the thing more thoroughly than I had before. I took and consulted with Henshaw, and I know I discussed it with Mr. Linden of Alexander and Baldwin, although he was also at that [246] time our tax consultant, and came to the conclusion by the end of the year that the note was valueless, and in order to take and get a proper balance sheet we should wipe it off and also claim it as a tax deduction in the year in which we determined the note to be valueless.

Q. Well, now, in that determination did you make any inquiry about the assets that were remaining?

A. Oh, yes. I talked that over. I had seen the balance sheet and I talked with Henshaw and also with Bottomley.

Q. And did you make any other inquiries from any other note holders or others who had investigated it?

A. At some time—I don't know just when it was—when the question came up when these notes should be written off or whether the committee, advisory committee, should continue to function and the assets of the Waterhouse Trust Company be kept separate and distinct. Now, whether that was in 1931 or not, I have forgotten. But I do remem-

(Testimony of Sherwood M. Lowrey.)

ber that when that subject did come up I said, so far as American Factors was concerned there is no longer necessity for any advisory committee for the reason that we had already considered the note of no value and had written it off.

Mr. Atherton: Your Honor, I move to strike that, because that is contrary to the stipulation.

Mr. Wild: No, it isn't, your Honor. [247]

Mr. Atherton: Just let me say what I have to say, please.

Mr. Wild: Nothing that conflicts with the stipulation.

Mr. Atherton: In here it says, in paragraph 21 of the stipulation, it says that the proposal No. 1 mentioned in the letter of December 19, 1933, was agreed to. In other words, they didn't decide—and American Factors was one of the parties—did not decide to abrogate the committee, but that the note, that the account should be continued to be carried on the books of the Bishop Trust Company.

Mr. Wild: Well, may this witness go on and explain the whole situation?

The Court: That won't keep the witness from expressing an opinion at that meeting that so far as American Factors were concerned they would be satisfied that the committee would be done away with.

Mr. Atherton: American Factors, your Honor, was present at that meeting and were one of those who voted to continue the committee.

(Testimony of Sherwood M. Lowrey.)

The Court: Yes.

Mr. Atherton: Now, whether he expressed the opinion or not, I think is immaterial.

The Court: . Well, I think so, too.

Mr. Atherton: What action the committee took.

The Court: I think so, too, it is immaterial what discussion was there. The net result of the meeting is the only [248] thing that is material.

Mr. Wild: May he explain his vote, why he so voted?

The Witness: Simply this: I expressed my opinion. The majority wanted the advisory committee continued and the segregation of the assets maintained. And I said, all right, it doesn't do us any harm, go ahead and do it that way if you want.

Q. Now, in the year 1932, who have you to say as to whether you, as treasurer of American Factors, Limited, caused this \$50,000 to be written off the books of American Factors, Limited?

A. What did I do to cause it to be written off?

Q. Yes. Or did you? What did you do with regard to that debt?

A. When that decision had been reached by a conclusion reached by myself, after conferring with others, I remember discussing it with Bottomley and he agreed——

Q. What did you do on the books or accounts?

A. I gave instructions to the accountant to write it off, charge profit and loss with it and credit the note, and that is that for the year's operation.



(Testimony of Sherwood M. Lowrey.)

Q. And was that done on the books of the corporation that year? A. Yes.

Q. Do you have the excerpt from the books? Do you want [249] the excerpt of the books?

Mr. Atherton: Your Honor, it was stipulated that it was written off, and there is no dispute about that.

Mr. Wild: Well, no further questions.

The Court: That is merely the mechanics of it.

Mr. Wild: I think no further questions.

### Cross-Examination

By Mr. Atherton:

Q. I'd like to ask you, Mr. Lowrey, when Mr. Bottomley made that statement to which you alluded in your testimony?

A. Well, I sort of quoted him several times. The statements he made to me about loaning the money in the first place were made early in the year, January, say to the middle of February, somewhere in there.

Q. What was the occasion upon which he made those statements to you?

A. As I remember it, he merely came in the office and said, "Sherwood, we have got to do this, and this is what I have obligated to the company, what I have obligated the company to after conferring with some of my outside directors."

Mr. Wild: Did you have a duty to perform at that time? What duty did you perform for the

(Testimony of Sherwood M. Lowrey.)

company at that time? That's what he is getting at.

The Witness: Is that the question you want?

Mr. Atherton: No, I was trying to get the background [250] surrounding it, or, as Mr. Wild put it, the *Res gestae* of the situation when Mr. Bottomley made these comments to you about why the company was ready to participate with others in making the contribution to the \$400,000 fund.

The Witness: I think that I explained that formerly, that they were short of cash.

Q. (By Mr. Atherton): No, I am asking what was the occasion on which he brought that up?

A. What is that?

Q. What was the occasion when he brought that up?

A. Well, I was treasurer of the company. If he promised to loan somebody some money and going to get a note for it, he would come and give me instructions so I could get a check issued by the cashier's department to give to somebody so that in turn I could get the note to complete the transaction.

Q. Wasn't that a mere formal function that didn't require any discussion between you and Mr. Bottomley as to why the company was making the loan, and wasn't it just a perfunctory performance in drawing the note and signing it?

A. If he had asked me, if he had come to me and he called me "Sherwood" and he said "Sherwood,

(Testimony of Sherwood M. Lowrey.)

I want a check payable for \$50,000, payable to Henry Waterhouse Trust Company," I wouldn't have given it to him. I'd say, what is it for, [251] what am I going to do, what voucher are you going to give me, what shall I charge the money to? I was responsible for the keeping of an account of that under the by-laws of the company.

Q. Well, at that time were you informed that the board of directors had authorized the payment?

A. They had not authorized it at that time. Some of the outside directors had approved it. And later on the whole matter was brought before the board, at which time the action of Mr. Bottomley was ratified.

Q. Then at the time that the check was drawn and the advance made there had been no formal action taken by the board of directors?

A. No formal action, no, sir.

Q. So the occasion was then rather explanatory of why Mr. Bottomley was asking you to draw the check, is that it? That was the occasion for it? Because there had been no formal action?

A. Yes, certainly. He told me the set-up and that so and so and so and so had consulted with that and they had decided it was the wisest thing to do.

Q. Now, at that time did you have any discussion with Mr. Bottomley as to what he believed to be the prospects of the company recovering repayment of that \$50,000?

(Testimony of Sherwood M. Lowrey.)

A. Yes, he told me that the shareholders had already [252] put in \$200,000; that after going over the thing very carefully, the various ones involved in these loans, they had come to the conclusion that it was to the best interests of the community, and therefore to American Factors, that Waterhouse Trust Company be assisted by the loaning of this cash, and if the money was so loaned he felt there is a perfectly reasonable chance of getting the money back.

Q. Did he give you his reasons why he thought that, why he had reached that conclusion?

A. I can't go and think back to the details as far as that. He said they were short of cash; lots of companies have been short of cash; and when their cash position has been improved it had saved them from being insolvent. It was a banking proposition.

Q. Well, now, on the books of the company that note was set up as a contingent liability?

A. No, sir, it was set up as a perfectly good asset on our books.

Q. A note was set up?

A. The note was set up as any other asset in our books. We had paid out \$50,000 and note receivable had been charged with. Therefore, it appeared as an ordinary asset in our books.

Q. Now, with respect to that Exhibit M which is attached to Exhibit P-11, the stipulation No. 1, being the letter [253] dated July 18, 1932, addressed

(Testimony of Sherwood M. Lowrey.)

to American Factors by the Henry Waterhouse Trust Company, signed by Mr. Henshaw, was any formal reply made by American Factors to the Henry Waterhouse Trust Company as requested in that letter concerning the proceeding that the note was worthless?

A. None that I have any recollection of.

Q. During the year 1932 was any discussion had by any of the officials or members of the board of directors of American Factors concerning any information they may have received about a possibility of a merger of the Henry Waterhouse Trust Company into the Bishop Trust Company?

A. Nothing so far as I know, as member of the American Factors' board. Certain members of the American Factors' board without question knew about it because some of them sat as directors on both the Bank of Hawaii and the Bishop National Bank. But nothing that I know of.

Mr. Atherton: Very well. Thank you.

Mr. Wild: Wait a minute. Did you hear that question?

The Witness: Will you repeat that question?

(The reporter read the last question.)

Q. (By Mr. Wild): But you yourself knew about the proposal to merge Henry Waterhouse Trust Company and the Bishop Trust Company by the end of the year 1933, did you not?

A. To be perfectly frank, I don't remember.

Q. Well, you met on the committee, did you not,



(Testimony of Sherwood M. Lowrey.)

to determine whether the Bishop Trust Company, Limited, was going to be required to keep an account in its books after a merger?

A. Yes, that is clear.

Q. But prior to that time you didn't know anything about the merger, is that it?

A. I don't know when that first question of the merger came up. But it did come up, for the simple reason the question came up of whether or not the accounts from the Waterhouse Trust Company we brought over to the Bishop Trust Company should be merged right with the Bishop Trust Company accounts, or whether they should be kept separate and distinct. And later on it was decided by a majority of these note holders that it would be to the best interests to keep them separate.

Q. (By Mr. Atherton): When was the first discussion about the possibility of the merger? When did that first occur?

A. I don't know, Mr. Atherton.

Q. You didn't hear, or did you hear, during the year——

A. I was not on the Bishop Trust Company board. I was not on the Waterhouse Trust Company board. And when they first began talking about it, I don't know.

Q. You don't know?

A. So far as I know, the first thing that I knew about [255] the whole thing was the early part of '31 when Bottomley came in and told me about the

(Testimony of Sherwood M. Lowrey.)

loaning of the money to the Waterhouse Trust Company. Then, after that, what took place as far as dates go I do not remember.

Mr. Atherton: Very well. Thank you.

Mr. Wild: No further questions.

(Witness excused.)

The Court: Well, we are going pretty slow. Alexander and Baldwin, will they have any witnesses?

Mr. Pratt: Yes, your Honor. We have two witnesses, I think, with respect to our case, that we expect to call.

The Court: Well, now, when can we entertain those witnesses? The first thing in the morning?

Mr. Pratt: Your Honor, I think Mr. Wild has three or four more on this issue.

The Court: Witnesses?

Mr. Wild: Yes, I have.

The Court: They will be short witnesses?

Mr. Wild: I hope so, your Honor. I don't know, of course. I expect they will be very short witnesses.

The Court: Hadn't we better start a little earlier than 10 o'clock tomorrow? I am getting quite apprehensive that this thing is going to run beyond the estimates you gentlemen gave me, three days being ample. We have been at it two good, long days now, and the plaintiff hasn't gotten near its closing. I don't know what the Government is going to have.

Mr. Wild: Do you intend calling any witnesses? I was going to review tonight the witnesses I was going to call and get in touch with them and locate them, to be sure that I can have them in court the first thing, your Honor. And if I do that too early, I won't be able to locate them maybe.

The Court: Well, you can at least reflect on the matter and hold them down to the essentials.

Mr. Wild: Very well. Is it your Honor's pleasure to start at 9:00 o'clock or 9:30?

The Court: Well, I don't want to impose on counsel's time.

Mr. Wild: Well, would 9:30 be all right? You see, your Honor, tomorrow morning or this afternoon, it is hard now to locate them some time. I have got to locate Al Castle, for instance. Al Castle represents a note holder. W. Frear I think I can get. I don't think I can get all tonight. There is a possibility of calling J. C. Clarke. These witnesses are all in connection with the Henry Waterhouse Trust note, and they will be brief witnesses. And E. J. Greaney, who made the report of the audit, I want to get him. And I told him that I'd try and put him on and let him go as soon as I could. So that those would be the witnesses I have. And I will try to locate them and get them here the first thing in the morning. [257]

The Court: Is there anything on the criminal calendar in the morning?

The Clerk: No, your Honor.

The Court: Well, suppose we say 9:30. Would that be all right?

Mr. Wild: We shall try, your Honor.

The Court: All right.

Mr. Wild: I am more anxious to conclude than your Honor.

Mr. Atherton: I'd say 9:00 o'clock.

Mr. Wild: You don't have a thing to do. You just sit there. I've got to locate my witnesses.

Mr. Pratt: Your Honor, with respect to the Alexander and Baldwin witnesses, I don't want to have them sitting here all morning. If the Court thinks perhaps we could arrange to have them here the first thing in the afternoon, it would seem to me that the four witnesses will probably take the morning.

The Court: Do you think they will, Mr. Wild?

Mr. Wild: They certainly won't from my examination.

The Court: I wouldn't think so.

Mr. Pratt: Well, then, I will have them here in the morning, your Honor.

Mr. Wild: You won't need them for an hour.

Mr. Pratt: Both of mine will be short and perhaps if I have them here by 10:30, there would be ample time. Mr. [258] Wild certainly won't finish with four of them in an hour.

The Court: Ten-thirty you suggest?

Mr. Pratt: That was my suggestion, that I have them here by then, or eleven o'clock.

The Court: Well, make it 10:30.

(The Court adjourned at 4:10 p.m.) [259]

November 14, 1947

(The Court convened at 9:40 a.m.)

The Clerk: Civil No. 419, American Factors, Limited, versus Fred H. Kanne, Collector of Internal Revenue, defendant; case called for further trial.

Mr. Wild: Ready to proceed, your Honor. I must say I had a little difficulty getting witnesses last night, but I am hoping to boil this right down so that we can finish by noon. Mr. Singlehurst, will you take the stand. They are just checking something, your Honor. If I may ask your indulgence.

The Court: Yes.

Mr. Wild: I only got these witnesses a few minutes ago, your Honor. I wonder if it would be appropriate, while we are waiting for the check, to state to your Honor what this matter is? I have asked the treasurer of the Bishop Trust Company to come forward with the bank examiner's report of the condition of the Henry Waterhouse Trust Company, Limited. I have had copies made of excerpts from that report, which is the complete letter with two schedules annexed. And we would want to offer that in evidence. Are you ready?

Mr. Atherton: Your Honor, I think the whole report should be put in, the whole report of the bank examiner, not certain excerpts, if it is going to be offered in evidence. [260]

The Court: Well, the report, that is, the whole



report of the bank examiner is upon the subject of the Henry Waterhouse Trust examination?

Mr. Wild: Yes, your Honor.

The Court: I think myself that the whole report should be put in, if you are going to put in part of it, unless first the whole report is submitted for examination to your opponent and there is an agreement as to some particular part of it.

Mr. Wild: Well, your Honor, I have put in everything but supporting schedules. The summation of all the data is in the part that I have had typed up. I don't see any reason to clutter records with pages and pages of itemized valuations which aren't going to be relied on by item. And I don't see why the Court's time should be bothered by them.

The Court: But in the face of an objection to your picking out just what you might consider favorable to you, out of a report, without exposing, putting in the entire report, it certainly is an objection that should be sustained.

Mr. Wild: Well, your Honor, we don't want anything—we are exposing the whole report for examination. Would you come forward, then? (To a witness.)

The Witness: I have not completed yet.

Mr. Wild: I will state my position, your Honor. If there is anything else in the report that counsel would like to go in, that is all right. We will make copies and furnish [261] them.

The Court: Has opposing counsel examined the report?

Mr. Wild: I don't know.

The Court: Have you submitted it?

Mr. Wild: No, because this is on file in the office of the treasurer of the Territory, your Honor, a copy of it, and it is open alike to the United States Government and to ourselves.

The Court: But if he didn't know that you were going to use some part of it, why, naturally he wouldn't have any occasion to go over there and examine the entire report.

Mr. Wild: Well, he asked me about the report, your Honor, and that's what called it to my attention.

Mr. Atherton: I asked you about it?

Mr. Wild: Yes.

Mr. Atherton: It is a complete surprise to me. I don't recall that, but I am not going to contradict counsel. But it is a complete surprise to me. Otherwise, I would have inspected the records of the bank examiner myself personally if I had any idea that this was going to be offered. It is the first indication to me that there was any such proposal going to be made.

Mr. Wild: Well, your Honor, may I proceed? Because I am sure that once counsel inspects the thing he will have no objection. [262]

THOMAS G. SINGLEHURST

a witness in behalf of the Plaintiff, being duly sworn, testified as follows:

Mr. Atherton: Your Honor, before the witness proceeds, may I ask for your ruling on the admission of this partial report?

Mr. Wild: Well, I haven't offered it.

Mr. Atherton: Oh, I thought you had.

Mr. Wild: I was merely explaining while we were waiting what was going forward. I haven't offered any of it. The Judge hasn't seen it.

Direct Examination

By Mr. Wild:

Q. Will you please state your full name?

A. Thomas G. Singlehurst.

Q. And what is your present residence?

A. 4465 Kahala Avenue.

Q. City and County of Honolulu?

A. Correct.

Q. How long have you been a resident of Honolulu?

A. Forty-eight years.

Q. And what is your present position?

A. Vice-president and treasurer, Bishop Trust Company, Limited.

Q. How long have you been such officer, as treasurer [263] of the company?

A. Since 1937 or 8, I believe.

Q. As treasurer of Bishop Trust Company, Limited, do you have under your custody and con-

(Testimony of Thomas G. Singlehurst.)

trol official records rendered to Bishop Trust Company?      A. That's correct.

Q. And I will ask you whether or not you have under your custody and control a bank examiner's report of the condition of Henry Waterhouse Trust Company, Limited, at the close of business December 31, 1932?      A. I have.

Q. At my request have you produced the original of that report?      A. I have.

Q. Will you exhibit it? Is that the true report you have in your hands?

A. This is it. (Showing a document.)

Mr. Wild: I would ask that that be marked Exhibit P-13, your Honor, be received in evidence.

Mr. Atherton: That is the entire report?

Mr. Wild: The entire report.

Mr. Atherton: You are offering the entire report?

Mr. Wild: I am offering the entire report.

(The document referred to was received in evidence as Plaintiff's Exhibit P-13.) [264]

Mr. Wild: Now, I will furnish for the convenience of counsel and Court a digest of that. And I am perfectly willing to recall to the Court's attention anything they want. You have examined this excerpt from the report which I have handed you?

The Court: What is the date of that report?

Mr. Wild: As of the close of business December

(Testimony of Thomas G. Singlehurst.)

31, '32, for that period as at the end of the year '32, your Honor.

Mr. Atherton: Your Honor, may I state that the report is dated July 20, 1933.

Mr. Wild: It was completed after the end of the year, your Honor, because otherwise it wouldn't have the year-in statements in it.

The Court: All I wanted was to get it for identification.

Mr. Wild: Yes, your Honor.

Q. I will ask whether you have checked that letter against the original report which is in evidence? A. Yes.

Q. And the schedue of statements, Exhibits A and B annexed?

A. I checked practically all of Exhibit A. I didn't complete Exhibit B.

Mr. Wild: Well, I will offer that as 13-A, your Honor, as explanatory in a shorthand method, the gist of the whole report. I think it is for the convenience of Court and counsel. [265] And then I would ask counsel at his leisure to examine the rest of the report, and if there is anything else he wants in there, all right. And if not, that we be privileged to withdraw the original report because it is an official record.

Mr. Atherton: Your Honor, I object to picking out this and offering this subsidiary statement—well, the whole report is in evidence now. If he wishes to examine the witness with respect to cer-



(Testimony of Thomas G. Singlehurst.)

tain items in the report, why, there is no objection. But I think that it is redundant to offer the supplementary statement when we have got the entire report.

Mr. Wild: Well, I am offering the supplementary statement so that we may withdraw the original report after counsel has examined it and found that he doesn't want anything else in there. And if he does, I will type it and have it copied and put in.

Mr. Atherton: Your Honor, I have to have my objection to withdrawing the original report. I don't want to be put to the task of determining forthwith just what part of that original report is——

The Court: All right. Sustained.

Mr. Wild: May we have an exception? No further questions.

(Witness excused.)

Mr. Wild: Your Honor, I am trying to cut this as short as I can. [266]

EDWARD J. GREANEY

a witness in behalf of the Plaintiff, being duly sworn, testified as follows:

Direct Examination

Mr. Wild: May Mr. Cades examine Mr. Greaney?

The Court: Yes.

By Mr. Cades:

Q. Mr. Greaney, what is your occupation or profession?

A. I am a certified public accountant.

Q. And you have been engaged in public accounting for quite a number of years?

A. In Hawaii since 1930.

Q. And in the course of your profession as a public accountant, were you ever consulted with respect to the Henry Waterhouse Trust Company?

A. I was. I was asked to do, to make an examination back in 1930.

Q. Do you recall when in 1930?

A. The latter part of November.

Q. And do you recall who engaged you?

A. I was engaged by Mr. A. W. T. Bottomley.

Q. Will you explain the nature of your engagement, what you were asked to determine?

A. Well, Mr. Bottomley called me to his office some time late in November, 1930, and told me that circumstances required that an examination be made of the books and accounts [267] of Henry Waterhouse Trust Company under circumstances whereby it had to be kept confidential and not be made public

(Testimony of Edward J. Greaney.)

that the work was being done. And I undertook that job somewhere along the latter part of November or the first part of December, and worked on it all the way through until about the middle of February; February 14, 1931, was the date of the report that was eventually made as the result of the examination, of the work that was done.

Q. Did he explain to you anything about the circumstances that made necessary the engagement?

A. Yes, he told me that a short time before that—I might first preface my remarks by saying that that is 17 years ago, and I am relying on my memory; also after having looked up, studied the report, reviewed the report and work papers—but he told me that a short time before that an additional stock issue had been put out by the Henry Waterhouse Trust Company——

Mr. Atherton: Your Honor, I think the testimony of the witness along this line is inadmissible on the ground of immateriality and irrelevancy. He has been called to the stand to testify with respect to the report he made on an examination.

Mr. Wild: No, we called him for his testimony, your Honor.

The Court: Sustained. The witness is going beyond the [268] question.

Q. (By Mr. Cades): Will you explain the problem that was put to you at the time of your engagement?

The Court: A little louder, if you please. The

(Testimony of Edward J. Greaney.)

current of air through the windows here makes it somewhat difficult for me to hear.

Q. Will you explain the problem that Mr. Bottomley presented to you for inquiry at the time of your examination?

A. Well, he presented it to me as a problem that had the appearance of the financial situation of the Trust Company that would require some special assistance to it, because of the fact that the balance sheet and statements of the company that had been shown to him indicated to him that the receivables or a substantial part of the assets were somewhat frozen; and that there were deposit accounts there, if demand was made for payment of them, the company would have difficulty meeting the demands because of the shortage of cash and the frozen condition of some of the receivables, substantial part of the receivables.

Q. In connection with your engagement, just what did you do?

A. Well, started in working somewhat on my own with the idea of trying to evaluate the assets, mostly the receivables. The principal part of the assets was receivables. After the [269] job had gone along for awhile, working by myself and reporting tentatively as I went along to Mr. Bottomley, he suggested and made arrangements whereby Mr. Wallie White of the Bishop Trust Company assisted me, worked along with me and assisted me on the work. A little further along other officials

(Testimony of Edward J. Greaney.)

of the Bishop Trust Company also worked on the valuation of the receivables.

Q. Did you have any discussions with any other people except Mr. Bottomley and Mr. White during that period?

A. Others of the Waterhouse Trust Company, you mean?

Q. Concerning the matter that you were working on.

A. Only officials of the Bishop Trust Company eventually. And Mr. Campbell of the Waterhouse Trust Company.

Q. And you prepared a report as of the condition of the company at February 14, 1931?

A. Report was made as of February 14, 1931. It was based largely so far as the valuation of the assets was concerned as of January 31, 1931.

The Court: January 31, 1931?

The Witness: 1931, yes, sir.

Q. So that there was a 14-day period between the date that the plan that finally developed out of the examination was consummated and the date as of which your report was made?

A. That's right.

Q. How did you go about setting values in determining, [270] in making up your report? What was the procedure you followed?

A. Well, each type of receivables required a different type of approach to determine whether it was good or bad or doubtful. Those receivables



(Testimony of Edward J. Greaney.)

that were collateral loans that had stocks and bonds behind them, of course, we valued the bonds; we placed the value of the stocks and bonds and determined whether or not the collateral was equal to or in excess or short of the balance due on the receivables. Others that were unsecured accounts we tried to determine whether or not the individual was good for it or whether the amount involved was too big or to expect full payment from them, or the nature of the account in the first place, how it arose, whether it was a stock transaction, or loans or mortgages, and so on.

Before the final figures were put together we had the benefit of several officials of the Bishop Trust Company who were trust officers and who were familiar with the values of real estate and that sort of thing, real estate mortgages; we had the real estate appraised or attempted to place values on it ourselves as best we could.

Q. And did you reach a final estimate of what—I will reframe that. Did you reach any figure as a result of those valuations that was placed on the assets?

A. Reach a figure as to the amount of losses to be expected? [271]

Q. Yes.

A. Why, I have gone back and reviewed the work papers and the summary of the schedules that was made up, and the figure as shown there is the

(Testimony of Edward J. Greaney.)

total of a column that is headed "losses" equals to a million five hundred odd thousand dollars.

Q. And did that include any figure for a loss on the Shingle and Campbell transactions?

A. That was the figure based on the January 31st balances. And that figure included something like \$727,000 in the loss column representing receivables against Shingle and Campbell. Between them and February 14 the Shingle and Campbell accounts were cleared up by the payment of cash, according to the figures there, and I think it shows in the report of some \$635,000. So that the eventual loss, the actual loss sustained in the Shingle and Campbell account was something short of a hundred thousand dollars; whereas the original figure included in the million and one-half loss was seven hundred twenty-seven thousand dollars.

Q. And the actual known loss on the Shingle and Campbell account was known before February 14, 1931?

A. The loss was, the actual loss was known and shows in the report as \$98,900 odd.

Q. Now, then, taking those figures of losses, how was the figure of one million and eighty thousand odd dollars, which is shown as the reserve on your statement of February 14, [272] 1931, after reorganization, as shown——

Mr. Atherton: Excuse me. Your Honor, don't you think that the report of the auditor should be in evidence so that you can examine it and see what

(Testimony of Edward J. Greaney.)

Mr. Cades is talking about? I mean, he is reading from papers in his hands. There is nothing before you.

Mr. Cades: If your Honor please, I was just about to identify the record that I am looking at, which is an excerpt from the report. We have stipulated to certain portions of the report of Mr. Greaney that we deemed material in this issue. And that is already in evidence as Exhibit K of P-11, attached to P-11.

Mr. Atherton: Well, all I am trying to make clear to your Honor is so that you can see what he is talking about. I think if you will refer, your Honor, to that exhibit in the stipulation, perhaps it will enable you to follow the testimony. It is Exhibit A referred to in stipulation 2. It is Exhibit P-11; stipulation No. 1, Exhibit A.

Mr. Cades: Exhibit K attached to P-11.

The Court: Yes.

Mr. Cades: May I withdraw the question?

The Court: Entitled "Henry Waterhouse Trust Company Balance Sheet"?

Mr. Cades: That's correct.

The Court: I assume that that has emanated from the [273] Waterhouse Trust Company and is a true reflection of the state of the accounts on their books on that day.

Mr. Cades: That is correct, your Honor. That has been so stipulated.

Mr. Atherton: Your Honor, if you will look at

(Testimony of Edward J. Greaney.)

Exhibit A attached to that stipulation, I think you will understand the testimony more clearly. He is talking about an item now, estimated losses of \$1,080,803.15. I don't think it is too clear from the examination of the balance sheet, because that item of losses doesn't appear on the balance sheet. A loss is a nominal account and not a real account, and the balance sheet represents the real accounts.

The Court: Is this the balance sheet that the witness made up from the books?

Mr. Cades: This balance sheet——

The Court: Where did this come from?

Mr. Cades: Exhibit K was made up from the reports and the books of the Henry Waterhouse Company.

The Court: By whom?

Mr. Cades: Well, that I don't know. I believe that was made up at the request of the Government and furnished to them in some prior cases. And those, I believe, appear in the report of cases before the Court of Tax Appeals.

The Court: Well, this is not the work of Mr. Greaney?

Mr. Cades: Well, it is prepared from information, from [274] information supplied by him. It is just another form of his own reports. In any event, I believe that Mr. Greaney as an expert could testify as to what the figures mean.

The Court: Yes. Well, that is all right. Go ahead unless there is some objection.

(Testimony of Edward J. Greaney.)

Mr. Cades: But to indulge counsel for the Government, I will refer Mr. Greaney to Exhibit A where a figure of \$1,080,803.15 appears as estimated losses.

The Court: Where does that appear?

Mr. Cades: That is in Exhibit A, your Honor, of the same Exhibit P.

Q. That is a copy of your Exhibit A, of the audit report you made as of February 14, 1931?

Mr. Atherton: Your Honor, if you will allow me to help you on this, if you will look at page 4, the stipulation of facts, you will find in paragraph 5 that Mr. Cades is talking about, Exhibit A mentioned in there which is Exhibit A annexed to the stipulation, that is the part taken from Mr. Greaney's report, audit report. It was Exhibit A attached to his report. And that is the picture for you to follow.

The Court: Now, you are examining him on Exhibit A or Exhibit K?

Mr. Cades: Exhibit A. And I will ask him later, if your Honor please, to tie that in with Exhibit K, to show what the connection is and how this was later reflected on [275] the books.

The Court: Well, now, as I got it, this balance of estimated losses against reserve, \$779,717.23, was arrived at, that estimate was arrived at by depreciating the tables concerning the debit of Shingle and Campbell?

Mr. Cades: That is correct.



(Testimony of Edward J. Greaney.)

The Court: To a very large extent? That they made that good to the extent of some six hundred some odd thousand dollars?

Mr. Cades: That's correct.

The Court: All right.

Mr. Cades: And I would now like Mr. Greaney to explain how the figure of \$1,080,000 odd was arrived at as shown on Exhibit A attached to P-11.

The Witness: Exhibit A, as I see it here, looks to me like it is an exact copy of what was Exhibit A in my report, as Government counsel said. So that the figures are identically the same. Now, then that million and eighty thousand dollars is, as it is shown there, somewhat of a balancing figure to make up the one million eight hundred fourteen thousand dollars which is the difference of it, or the one million and eighty is the difference between the one million and eight hundred fourteen thousand and the seven hundred thirty-three thousand dollars representing the Shingle and Campbell account. Now, then, the one million-eight hundred [276] fourteen thousand dollars, according to my work papers, is made up first of the million five hundred forty-eight thousand dollars about which I just testified, plus approximately two hundred sixty thousand dollars more that was added in there to make these figures balance out, for two reasons: one being that between the January 31st scheduled preparation and the February 14, 1931, Shingle and Campbell had paid in the six hundred thirty-five thousand

(Testimony of Edward J. Greaney.)

dollars for one thing; also, in making up the balance sheet of February 14th we had to take into account that there was an operating, that the company was operating and had gone on from January 1st to February 14th and during that period the books reflected a loss of ten thousand one hundred forty-nine dollars.

Now, then, going back to the million and eighty thousand dollars, that is the figure which—the four hundred thousand dollars paid in by the note holders, after that would be paid in and added to the six hundred eighty thousand dollars, that shows as the net worth on the balance sheet, would make up the one million eighty thousand dollars.

Q. In other words, do I take it that the loss, the estimated loss was raised in order to wipe out any equity above the actual estimated losses?

A. The contingency——

Mr. Atherton: Your Honor, that is a leading question. I move that that be stricken and that he rephrase the question. [277]

Q. (By Mr. Cades): Mr. Greaney, you mentioned a figure of two hundred sixty thousand dollars being added to the estimated loss. Will you explain what that two hundred sixty thousand odd represented?

A. The two hundred sixty thousand dollars represented a cushion in effect and had the effect of being a cushion to take care of any losses over and above the amount that was put in the loss column

(Testimony of Edward J. Greaney.)

on the schedule that was prepared covering the individual receivables that were on the books.

Q. And that was done for what purpose?

A. That was done because by the time we got around to preparing the final report and putting the figures together, the Bishop Trust Company had agreed to take over the operation of the Waterhouse Trust Company and had changed its position somewhat from a position it had taken somewhat shortly prior to that time, that they would pay something for the stock. And as it finally turned out, they refused to pay anything for the stock so that the reserve for contingencies was made to balance up so that it would appear proper to pay nothing for the stock.

Q. In setting the loss figures for the assets, what kind of policy was followed? Were you conservative? Were you liberal or what were the loss figures set?

Mr. Atherton: That calls for a conclusion, your Honor. [278] I move that that be stricken.

Mr. Cades: If your Honor please, it may have been a conclusion but this is the man that did the job. And he can tell us how he evaluated these figures, what kind of policy he actually used in determining the figures that were set down for this purpose.

The Court: Well, then, let him tell.

Q. Do you understand the question?

A. I wish you'd repeat the question.

(Testimony of Edward J. Greaney.)

(The reporter read the last question.)

The Court: I don't like the question in its form. You made a suggestion that the question is leading. If it is intended to inquire from the witness what method he used, that would seem to be all that is necessary to the question. What you want to get at is what method did he use in arriving at his valuations.

Mr. Cades: That is correct.

The Court: You may answer.

A. All of the receivables, and all of the other assets, were listed on schedules, long sheets, columnar sheets, and we attempted to put each individual balance in one or more columns on the schedule, based upon our valuation of it from the standpoint of its collectibility. Those items that were considered as uncollectible in full were put in the loss column. Those items that were considered as collectible in [279] part and then collectible in other part, the amount was split up and put—and the amount that would represent what we considered as uncollectible was put in the loss column. As we went along, of course, there were, of course, hundreds of these accounts and we had, of course, to change our views as we went along. The work progressed all the way from the latter part of November until some time early in February, 1931.

We had occasion, of course, to change our opinion on some of the accounts as additional information

(Testimony of Edward J. Greaney.)

was developed. However, as the valuation was being supervised, or at least I was working along with officials of the Bishop Trust Company who were eventually going to take over and did take over the operation of the Waterhouse Trust Company, and some of the officials were very severe in their views of the collectibility of these accounts to such an extent that we frequently had long knock-out and drag-out fights with them, so the eventual figure that showed on the loss column was the best judgment of all concerned but no doubt was influenced by the officials of the Bishop Trust Company in their views of trying to have them appear as great as possible.

The Court: As great?

The Witness: As great as possible.

The Court: The losses?

The Witness: The losses to appear as large as possible. [280]

The Court: I thought that's what you meant but I didn't quite get it.

A. (Continuing): One of the officials of the Bishop Trust Company, however, leaned in the other direction, leaned with me.

Q. Mr. Greaney, you mentioned a figure of ten thousand odd dollars as representing an operating loss from January 31st to February 14th, 1931. Will you explain that figure further?

A. Well, I have gone and reviewed my report and there is a schedule in my report that covers it.



(Testimony of Edward J. Greaney.)

Also the narrative part of the report explains that that represents the excess of the expenses for the month and a half, the excess of the expenses over the income as recorded on the books. But it wasn't customary for the company to accrue income, principally interest and dividends by the month. So I didn't accrue it for the purposes of this report. They followed the policy of accruing the interest and other income quarterly. So that the income as stated, or the income figures that were used that resulted in the ten thousand dollars operating loss undoubtedly were understated by all of the accrued income for the period of a month and a half. And the ten thousand dollars represents the excess of the expenses over the income. But the income not having been accrued.

The Court: Well, you say the income not having been [281] accrued. The income was accruing, was it not, but it wasn't credited?

The Witness: Yes, sir, that's what I mean, Judge.

Q. It wasn't set up?

A. It wasn't set up on the books.

Q. And you only used the figures on the books?

A. That's right.

Mr. Cades: That's all.

Mr. Wild: Might I ask a question? Are you going to examine this witness very long?

Mr. Atherton: Well, I can't tell that.

Mr. Wild: Mr. Castle is a very busy lawyer. If he can come up—I promised if possible, and if it

(Testimony of Edward J. Greaney.)

was agreeable to counsel and the Court, with the Court's permission, I would put him on as soon as he got here.

Mr. Atherton: Suppose I take only about 15 minutes.

Mr. Wild: No, I want you to take whatever time you want. Counsel evidently doesn't want to yield.

Mr. Atherton: Well, my idea is that it is fresh in my mind and I might as well proceed.

Mr. Wild: Very well. I wanted to live up to my promise to Mr. Castle.

Mr. Atherton: I understand. I don't think I am going to be very long. [282]

### Cross-Examination

By Mr. Atherton:

Q. Mr. Greaney, will you tell the Court, please, what information you had and those with whom you conferred in evaluating these various asset accounts of the Waterhouse Company as to the uncollectibility of the loans, and so on?

A. We had all the records of the Hawaiian Trust Company plus the combined experience of several Bishop Trust Company officials, and we also consulted with Waterhouse Trust Company officials. One of the men, Mr. W. A. White, who worked a great deal on it, was very familiar with the accounts of the Waterhouse Trust Company, he having been an employee previously of the Waterhouse Trust Company.

(Testimony of Edward J. Greaney.)

The Court: At that time he was an employee of the Bishop Trust Company?

The Witness: Yes, your Honor. But he had previously been a Waterhouse Trust Company employee.

Q. Did you actually talk with the debtors and look into their personal situation, financial situation, each and every one of them, to determine the possibility of collectibility independently of the opinion expressed to you by the Bishop Trust Company officials?

A. Not all of them, Mr. Atherton. We did consult with the debtors in some cases, particularly in the cases of those accounts that had very large balances or comparatively large [283] balances. We did not confirm, actually confirm all of the balances of the small accounts.

Q. What did you do with respect to the collateral?

A. We determined the value of all the collateral; where the stocks were listed stocks, we used the market quotations; where they were not listed stocks, we used whatever information we could get.

Q. As to real estate mortgages, how did you arrive at the value of the property behind the mortgages?

A. We had in some instances, we went and looked at the property ourselves. In some instances, in most instances, where there was need for so doing, we had real estate appraisers of either the

(Testimony of Edward J. Greaney.)

Waterhouse Trust Company or the Bishop Trust Company, and I think one or two instances independent appraisers give us their opinions on the value of the real estate.

Q. Did they render written appraisals or just oral appraisals?

A. I don't think we had much in the way of written appraisals. This was a pretty rush job and also during part of the period was a confidential job that required caution with respect to having it known that the work was being done.

Q. Now, as to local securities other than those listed on the New York Stock Exchange and other than those dealt with over the counter, how did you arrive at their approximate [284] fair market value on the date when you made your examination?

A. Well, I couldn't say specifically at this late date. We did the best we could; which means getting financial statements whenever it is possible, talking to people who are familiar with the financial affairs of the particular company, whenever that was possible. We had access, however, to information from people who were in the position to know a great deal about the business affairs of places around town. We had access to the officials of the Bishop Bank and the Bank of Hawaii, and we consulted freely with them.

Q. Now, with respect to these demand accounts that were outstanding, did you, did anyone determine for you, any lawyer advise you, or did you

(Testimony of Edward J. Greaney.)

determine yourself as to whether the statute of limitations had run against any of those accounts as to their collectibility?

A. I don't remember that we had that particular problem. I might say that at least two of the Trust Company officials who worked with us on it were lawyers.

Q. Do you know whether or not any of these debtors waived the statute and gave such consideration that would follow it?

A. I don't recall——

Mr. Wild: I object to that. He assumes something that is not in evidence. There is no evidence that any of these were—— [285]

The Court: Overruled.

A. I don't recall any instance where a question with regard to the statute of limitations arose. It may have, but I don't recall any question of that kind or any question on that particular point.

Q. Now, would you say, Mr. Greaney, that as a result of your investigation in 1931 that the Henry Waterhouse Company was insolvent?

A. That would be a difficult question to answer at this time. I will say that my impression at that time was that it was not insolvent.

Q. What was the basis of that impression?

A. The basis of that impression was that the value of its assets, as appeared to us by different summaries that we made as we went along, exceeded



(Testimony of Edward J. Greaney.)

the liabilities. That is my understanding of insolvency.

Q. Do you know whether or not the Territorial bank examiners had made an examination of the accounts of the Waterhouse Company in 1930 or 1931?

A. I don't recall, Mr. Atherton. I have a vague recollection of some point about the bank examiner in the picture, but I don't recall as far as I know. I had no contact with the bank examiner.

Mr. Atherton: That's all. Thank you, sir.

Mr. Cades: That's all. [286]

(Witness excused.)

Mr. Wild: Mr. Castle, will you take the stand. Thank you, Mr. Greaney.

### ALFRED L. CASTLE

a witness in behalf of the Plaintiff, being duly sworn, testified as follows:

#### Direct Examination

By Mr. Wild:

Q. Your name is Mr. A. L. Castle?

A. Alfred L. Castle.

Q. And you are a resident of Honolulu and have been for many years? A. That's right.

Q. And are one of the leading members of the Bar of this and other Courts of the Territory?

A. I deny that but I am a member of the Bar.

(Testimony of Alfred L. Castle.)

Q. And you have been for many years last past?

A. Yes.

Q. And you were at one time a stockholder in the Henry Waterhouse Trust Company, Limited?

A. That is correct, yes.

Q. And did you have any connection of any kind or sort with conferences with Mr. A. W. T. Bottomley concerning the Bishop Trust Company acquiring the capital stock of Henry Waterhouse Trust Company?

A. I did. [287]

Q. And where were those conferences held?

A. The talks I had with Mr. Bottomley were down in his office there at American Factors. I mean, speaking of the 1930 conference.

Q. Yes. About when did those start?

A. They started as far as I was concerned some time in the month of November of 1930.

Q. I see. And just prior to that had there been any change in the capital stock of the Henry Waterhouse Trust Company?

A. Yes, we increased the capital stock. I think it was doubled, as I remember it. And at any rate, we paid in pars for our new stock.

Q. And did you take up any new stock on that new increase?

A. I did. I took up 400 shares, paid in four hundred thousand dollars.

Q. And that was in the middle of October, before that?

(Testimony of Alfred L. Castle.)

A. It was in October, immediately prior to the November I speak of.

Q. Yes. And what was said at this first conference between yourself and Mr. Bottomley?

A. Well, I will have to go back just a little bit there, perhaps a good many years, but not very far. Bottomley and I talked prior to 1925, quite a bit, about the possibility [288] of the Bishop Trust and Waterhouse Trust combining in some way. And we had never got anywhere on the question of price. And so that by 1925 the conferences, the talks were discontinued. And I had promised then Mr. Bottomley that if any possibility of merger ever came out in so far as I was concerned that the Bishop Trust would get first chance. And in a way we sort of continued on from that talk. and I was——

The Court: Just a moment now. Bottomley, the reason you talked to him about that, Bottomley was a leading figure in the Bishop Trust Company, was he not?

The Witness: He was, yes, he was in the Bishop Trust, and then he was connected, of course, with the Bishop Bank in Hawaii and the Bishop Company. But he was connected with the Bishop Trust.

The Court: As well as being in the American Factors?

The Witness: That's right.

(Testimony of Alfred L. Castle.)

The Court: All right. Go ahead. Pardon me for interrupting.

A. (Continuing): And we discussed actively the Bishop Trust taking over or buying the stock of the Waterhouse Trust Company.

Q. And what time was that?

A. That was in November of 1930. And, yes, I left for San Francisco in connection with a law case on December [289] 5th, returning again the day before Christmas.

Q. Now, going back to that first conversation, was anything mentioned about price at that time?

A. Only that we talked about par. I mean a hundred dollars a share.

Q. And what was your motive at that time for suggesting the sale?

A. Well, I have been interested in this merger. Then, too, we increased this capital stock in the Waterhouse Trust Company, got in new cash into the concern. And during November, and so forth, with the large amount of demand accounts there I began to wonder about the liquidity of the Waterhouse Trust Company. And I felt that the merger with the Bishop Trust would strengthen that particular situation.

Q. Now, when you returned from the coast, did you again take up with Mr. Bottomley the question, did you take up the general question of acquisition?

A. Yes, I did. I couldn't—as I say, I got back

(Testimony of Alfred L. Castle.)

the day before Christmas and I didn't see him until some time after Christmas and the first of January.

Q. Well, what occurred at that time, if you recollect?

A. At that time apparently they had made, got some accountant, I think one was Mr. Greaney, to make an investigation of the affairs of the Waterhouse Trust Company. And Bottomley stated that they had this report and that the [290] investigation was still going on, and that he couldn't talk with me about any idea of any particular price until they had completed the investigation.

Q. Did you have further discussions with him concerning this at a later time?

A. Yes, only off and on. He was waiting that final report.

Q. Now, just prior to the time when Bishop Trust Company acquired the capital stock of Henry Waterhouse Trust Company, did you have any conversation with Mr. Bottomley relative to proposals to make loans to the Henry Waterhouse Trust Company?      A. Yes.

Q. Will you recount as nearly as you can where that conference or conferences took place and about when?

A. So far as I was concerned, it was down in Mr. Bottomley's office in the American Factors. And it would have been rather shortly before February 14th. How many days or whether it was in the latter part of January, I don't remember.



(Testimony of Alfred L. Castle.)

Q. And by February 14th you mean February 14th, 1931? A. That is correct.

Q. And what was said at the meeting in reference to the proposal that money be loaned to Henry Waterhouse Trust?

A. Mr. Bottomley wanted certain people or firms or [291] corporations to put up certain amounts of money, I think totaling around \$400,000. Anyway, that was the final amount. And he hoped that my father could come in for fifty thousand. And on behalf of father, after talking it over with him, we agreed to do it. That was to be on a loan basis.

Q. Was anything expressed to you whether or not there was any chance of getting repayment of that loan?

A. Well, Mr. Bottomley having gone into the matter, said that in his opinion there was no doubt that we'd be repaid.

Q. Did you have more than one conversation with Mr. Bottomley on that score, do you recollect?

A. Probably not over one more because I felt from what his investigation, statement, that it was a good loan.

Q. And actually that loan was made by your father? A. That is right.

Q. And was a note given to your father for it?

A. Yes.

Q. And do you remember anything else that

(Testimony of Alfred L. Castle.)

was said and done prior to February 14th or the consummation of this transaction about these notes or the collectibility of them?

A. No, I don't think so. Most of my conversations were directly with Mr. Bottomley.

Q. Now, Mr. Castle, you became a director of the Bishop Trust Company, Limited? [292]

A. Yes.

Q. At that time? And you know that on February 14, 1931, Bishop Trust Company, Limited, took over all of the capital stock of Henry Waterhouse Trust Company, Limited? A. Yes.

Q. Now, you recollect that there was a letter concerning the setting up of an advisory committee to the Henry Waterhouse Trust Company?

A. Yes.

Q. And were you—well, I can state to you, it is stipulated here that you were one of the advisors to the Henry Waterhouse Trust Company committee to go over the assets of the Henry Waterhouse Trust Company and advise concerning the collection and all other matters pertaining to that. You were the Alfred L. Castle who was a member of that committee? A. That's right.

Q. And did you serve on that committee?

A. Yes, I did.

Q. And what was that service, sporadic or did you give considerable attention to the affairs?

A. No, it was more than sporadic. I couldn't give you the number of meetings that we had. But,

(Testimony of Alfred L. Castle.)

we would go in there and there would be, as I remember it, Mr. W. A. White; he had prepared a great big sheet showing the various accounts and all that sort of thing. And we would go over those every now [293] and then, when you'd have a meeting with the committee. Other times one or two of us might drop in alone and check those matters over. You see, in 1931 when the thing occurred in February we were not so worried at that time about the financial condition because conditions in Honolulu were not as bad as they became later in '32 and even into '33. And so that more serious study of the situation came later than February of '31.

Q. Now, was there a complete restudy made of the assets of Henry Waterhouse Trust Company commencing early or in 1932?

A. Yes, very intensive.

Q. And did you participate in that study or revaluation of assets?

A. Yes, very definitely because I represented my father there.

Q. I call your attention to Exhibit M annexed to P-11 in evidence in this case, and ask you to examine that exhibit. (Handing exhibit to the witness.)

A. Yes, I remember such a letter. This, of course, is directed to American Factors, but, as I remember it, there was one directed to my father also.

(Testimony of Alfred L. Castle.)

Q. And you saw such a letter? A. Yes.

Q. And you will note that letter [294] refers to the fact that early in 1932 the advisory and financial committees of this company decided that it was advisable to reappraise all its assets.

A. That's right.

Q. Do you know of your own knowledge whether that is true? A. Yes, it is true.

Q. And it is further stated,

"\* \* \* an exhaustive reappraisal disclosed that its liabilities, other than those to the Underwriters and Stockholders, exceeded the value of its assets by a very considerable amount." A. Yes.

Q. Was that true?

A. That is true so far as we could ascertain.

Q. Then the statement is made,

"We are now quite confident, and accordingly advise you, that in our opinion the promissory note of \$50,000.00 above referred to is of no value whatever."

Did you, as a result of your study, come to the conclusion as to the value of the \$50,000.00 note in 1932?

A. Yes, I thought it was worthless and should be written off.

Q. I see. And how long a period of time was expended in these studies and reappraisals of the assets? [295]

A. Oh, a good deal of time there. Take in January, 1932, we went into those things very

(Testimony of Alfred L. Castle.)

carefully. These big sheets that we had, they would be put down "slow," "bad," "doubtful," "bad," and various designations on it. Then you'd take up that particular account and you might have other facts of your own. You might know the person, whether he was morally responsible, and whether he might have other assets somewhere or would be apt to come through. So that you took the account from all angles, not merely when it said the mortgage of \$40,000 and you found that the value of the land was twenty thousand. You didn't necessarily say that that was a loss to that extent then, but you went into the whole situation to see if there wasn't some possibility of recovery.

Q. Mr. Castle, you have been a director of Bishop Trust Company ever since? A. Yes.

Q. And you have been a member on that advisory committee ever since?

A. That's correct.

Q. Has any fact occurred since 1932 which would now cause you to change your opinion in '32 that that note became worthless in '32?

A. No, because towards the end of '32 conditions were worse and the Henry Waterhouse picture was worse than it was [296] in January of '32.

Mr. Wild: I see. No further questions.

#### Cross-Examination

By Mr. Atherton:

Q. Mr. Castle, you testified that you were al-



(Testimony of Alfred L. Castle.)

ways interested in a merger of the Waterhouse Trust Company into the Bishop Trust Company. Were you concerned about that and interested in effecting that merger as far back as 1930?

A. Yes, but that wasn't, there wasn't any worrying about financial reasons. The Waterhouse Trust and the Bishop Trust were two rather small trust companies. And it was just my own belief that they could be of better service to Honolulu by having a combination.

Q. You testified also that you believed the situation after 1931, say, 1932, was more serious with respect to the Waterhouse Trust Company than it was in 1931.

A. I think so.

Q. What is the basis of that?

A. It was general business conditions in Honolulu. There was a—the real estate market, for instance, as I remember it now, we had real estate people come in before the committee—the real estate market was going down, conditions were getting very much harder here. For some reason or other, I don't know why, there is always a lag here in Hawaii between here and the mainland. You had your tremendous [297] crash in '29 or so. Well, it didn't hit us so bad. We were on the way down somewhat in '31, but we got into about the worst in '32 and even into '33 it was rotten, too.

Q. Now, you also testified, Mr. Castle, that you thought that the Waterhouse note was worthless in 1932 and should have been written off.

(Testimony of Alfred L. Castle.)

A. Yes.

Q. Now, Mr. Wild has shown you Exhibit M which is attached to P-11. That is the stipulation of facts; being a letter dated July 18, 1932, which you testified as being the letter that was sent to your father.

A. That's right.

Q. Do you know whether or not your father formally wrote any communication to the Waterhouse Trust Company notifying them that he had conceded that the note was worthless in that year?

A. No.

Q. Have you any knowledge as to why he failed to do so?

A. No. For instance, when it came to the 1932 income tax return, we claimed then a loss of the note; I mean on behalf of my father, a loss of the note during that calendar year '32. I was one that felt all along that the thing was gone. I didn't care what the others did. Then later on, whether it was '33—it was '33, I think—there was some sort of a meeting there by which they sort of carried on with the [298] assets tagged, and so forth, and the majority of us voted to do that. But in my opinion there was no—the note was worthless, or I wouldn't have made the claim.

Q. Primarily why did your father fail to comply with the request contained in that letter of July 18th?

A. Some of the others didn't, and I don't know of any specific reason why he didn't, no.

(Testimony of Alfred L. Castle.)

Q. Do you know whether or not in 1932 the merger of the Waterhouse Company into the Bishop Trust Company that was effected in 1933 was under discussion between the officials of both companies and whether or not the note holders had knowledge of that prospective merger?

A. That thing I honestly don't remember, no. Just what the fact was, I do not remember.

Mr. Atherton: That's all. Thank you, Mr. Castle.

(Witness excused.)

Mr. Wild: No further evidence, your Honor. So far as American Factors is concerned, we rest.

The Court: Well, you put in that Territorial bank examiner's report.

Mr. Wild: Yes, your Honor. I'd like to read it.

The Court: For what purpose?

Mr. Wild: Well, I want to read it.

The Court: Is there anything in it?

Mr. Wild: Yes, your Honor. [299]

The Court: If you want to expose it to the Court——

Mr. Wild: Yes, if you'd rather I do that than examine the witnesses on the stand. You called the A. and B. case. They want to put on the evidence on this note. They've got witnesses. But I would like to call this to your Honor's attention.

The Court: Before you close, if there is anything in there that you want me to know about——

Mr. Wild: Yes, there is.

The Court: And you will stand aside for A. and B.?

Mr. Wild: Yes, I will. I meant to read this to your Honor before closing.

The Court: It is time for a recess.

(A recess was taken at 10:50 a.m.)

After Recess

Mr. Pratt: If your Honor please, in Civil Action 474, which is the proceeding by Alexander and Baldwin, Limited, we'd like to present to the Court——

The Court: What is the number?

Mr. Pratt: 474. We'd like to present to the Court a stipulation, stipulation 1.

The Court: You've got two stipulations?

Mr. Pratt: No, your Honor. But we just followed the same procedure as in the other matter. This stipulation one, your Honor, is identical with the one presented by American [300] Factors as stipulation one, the Exhibit P-11 in the other civil matter, with the exception of the first two paragraphs and paragraphs 24 to 27 inclusive. The differences with respect to paragraph 2, your Honor, are merely that this is Alexander and Baldwin, Limited, rather than American Factors. And the figures have been changed to represent those of Alexander and Baldwin. Counsel is willing, I believe, to agree that he has no objection to this stipulation except insofar as paragraph 2 is con-

cerned, that he makes the same objection that was made to the American Factors' paragraph 2.

And also with respect to paragraph 19, your Honor, that he makes the same objection there with respect to Exhibit M that he does not want it considered as stating facts that are true but will admit it to be the copy of the letter addressed to Alexander and Baldwin.

The Court: Yes.

Mr. Pratt: With respect to the paragraphs 24 to 27, your Honor, paragraph 24 merely states the method which Alexander and Baldwin kept its books and differs in that respect from the American Factors.

The Court: Kept on a cash basis?

Mr. Pratt: That's right, your Honor.

The Court: Well, that would mean that—yes, every year stands on its own bottom. [301]

Mr. Pratt: Well, your Honor, we have certain matters which we intend to have explained to the Court today with respect to the returns for '31 and '32. The next paragraph——

The Court: I think in passing now you had better elucidate that cash basis of accounting, just precisely what you mean by that.

Mr. Pratt: Your Honor, I'd rather have the witness explain, if I may.

The Court: All right.

Mr. Pratt: Paragraph 25, your Honor, shows the journal entries that were made with respect to this note. Paragraph 26 just refers to what



happened in the year '32 and is similar to the paragraph in the American Factors' suit. And paragraph 27, your Honor, concerns another deduction taken by Alexander and Baldwin, Limited, with respect to a thousand dollars contribution of Hawaii Bureau of Governmental Research. I don't know whether the Court desires to have that read or whether we may proceed without having that read.

The Court: Well, I am reading that now. This bureau was organized under laws of the Territory. It is rather lengthy. You had better read it.

Mr. Pratt: "In the year 1932 the Plaintiff contributed to the Hawaii Bureau of Governmental Research \$1,000. This bureau was organized under the laws of the Territory of Hawaii in 1928 by representatives of local business firms, and [302] membership was available to any taxpayer of Hawaii upon contribution of not less than \$10 a year.

"In operation, the Bureau of Governmental Research offers, and during the entire calendar year 1932 it also offered, gratuitous advice and assistance to the Governor of the Territory and governmental bureaus and agencies, usually at their request; studies and devises plans designed to effect efficiency and economy in governmental administration; analyzes proposed legislation and makes recommendations thereon to the territorial legislature; and supplies interested organizations, such as churches, chambers of commerce, and groups of citizens, with information and counsel on proposed leg-

islative measures. The bureau has no political aspects. Typical of the bureau's activities are a survey and suggested revision of the administrative organization of Maui County made in 1933 and an analysis of income tax returns made in 1934 at the request of an advisory committee on taxation to determine the ability to pay of various taxpayers.

"The bureau is supported entirely by its members' voluntary contributions which range from \$10 to \$10,000 a year. An attempt is made to interest all of the people of the Territory of Hawaii in the bureau and make it a citizens agency. Contributions to the bureau are made by corporations, individuals, and chambers of commerce. Definite amounts are [303] requested of the several members, apportioned on the basis of taxes paid, but each member is free to give what he wishes, and some members contribute at intervals longer than a year, or sporadically. About 75 per cent of the bureau's receipts come from corporations.

"In its federal income tax return for the calendar year 1932 the taxpayer deducted the amount of the above contribution as an ordinary and necessary business expense, and the Commissioner of Internal Revenue after investigation determined that the amount was not allowable as a deduction, for the reasons stated in his 90-day deficiency letter dated June 2, 1936."

I understand counsel has no objection to that.

Mr. Atherton: No objection to that.

Mr. Pratt: We'd like to offer this stipulation, your Honor, with the understanding that it will be subject to the same objection made by counsel, and I assume the same Court ruling.

The Court: Very well. The stipulation is received in evidence.

The Clerk: What designation shall we give this particular stipulation?

The Court: A. and B.'s Exhibit A.

The Clerk: A. and B.'s Exhibit A, Alexander and Baldwin Exhibit A. [304]

(The document referred to was received in evidence as Alexander and Baldwin, Limited, Exhibit A.)

Mr. Pratt: I'd like to call Dr. Dean. Your Honor, with respect to Exhibit M attached to that stipulation, it was noticed just as we came to court that the exhibit which is attached was a copy of the letter which was sent to Hawaiian Trust Company, Limited, rather than the letter which was sent to Alexander and Baldwin, Limited. Copies of the letter to Alexander and Baldwin are being made, and I understand that Government counsel is agreeable to the substitution of that letter in place of the Exhibit M now attached.

The Court: Yes.

Mr. Atherton: That's right.

The Court: That substitution to be Exhibit M?

Mr. Pratt: Yes, your Honor.

## ARTHUR L. DEAN

a witness in behalf of Alexander and Baldwin, Limited, being duly sworn, testified as follows:

## Direct Examination

By Mr. Pratt:

Q. Will you please state your name?

A. Arthur L. Dean, D-e-a-n.

Q. And you reside in Honolulu?

A. Yes, sir. [305]

Q. And have for how many years?

A. Thirty-three and something over.

Q. You are connected with Alexander and Baldwin, Limited?      A. Yes, sir.

Q. And how long have you been?

A. Since July, 1930.

Q. And what position do you now hold?

A. I am a director and vice-president.

Q. When you first became associated with Alexander and Baldwin, did you hold any position?

A. Not for the first few months.

Q. When did you become a director?

A. In November of 1930.

Q. And you became a vice-president in what year?      A. 1933.

Q. Now, Dr. Dean, in the stipulation the general character of Alexander and Baldwin's business is set forth. You had an opportunity to read the stipulation?

A. Yes, I looked through it.

Q. And in connection with the representation

(Testimony of Arthur L. Dean.)

of the five sugar companies and three pineapple companies, what financial arrangements are made with those principals?

A. We sell their products and receive payment therefor, the San Francisco office. We pay the bills for the purchases [306] which we make for them, which run into a number of million dollars a year. We file their tax returns and pay their taxes. And we honor their drafts for monies which they require for current operations, such as payrolls and ordinary expenses of running plantations and pineapple companies. The result of this situation is that a company may have either a credit balance or a debit balance. It makes no difference in our handling of the business, whether their accounts are on the credit side or on the debit side. There have been times at which a company's debit balance would run to over a million dollars. Ordinarily they are not as large as that. On the other hand, there will be credit balances, and we act as a sort of financial reservoir into which their income pours and out of which their needs are supplied, including, of course, payment of their dividends if they happen to be fortunate enough to be able to pay them.

Q. In the year 1930, when you first became connected with Alexander and Baldwin, what were the general conditions, financial conditions?

A. Well, at that time, in July of 1930, they were still pretty good in the Territory.



(Testimony of Arthur L. Dean.)

Q. And did they get worse or better?

A. They got worse.

Q. Did you, somewhere near that time, have anything to do with the Henry Waterhouse Trust Company matter? [307]

A. Yes, it was discussed by the manager, Mr. John Waterhouse, and assistant manager, Mr. Charles Hemenway, with the directors of the company, and informal approval was given for making a loan of \$50,000 and that informal approval was confirmed and ratified at the next regular meeting of the directors. I don't remember now whether the practice, which is fairly common, of circulating a resolution with places for the directors to indicate approval or disapproval, whether that was followed in this particular instance or not.

Q. Now, Mr. Waterhouse and Mr. Hemenway of whom you speak, are they living?

A. No, they are both dead.

Q. They held what positions?

A. John Waterhouse was the manager and Charles Hemenway was assistant manager.

Q. In those discussions which you had with Mr. Waterhouse and Mr. Hemenway, was anything said with respect to this, to the repayment of this loan?

A. I don't recall anything specific having been said about repayment.

Q. Did they state or did you discuss with them the reasons for making the loan?                      A. Yes.

Q. What were those reasons?

(Testimony of Arthur L. Dean.)

A. There were two basic considerations. The Waterhouse [308] Trust Company was very obviously in a dire need of liquid assets to meet obligations, and we had two things in mind really. One was the saving of the investments and monies of innocent persons who had placed their funds in the care of the Waterhouse Trust Company in one way or another. The other consideration was the maintenance of the integrity and stability of the basic business enterprises of the Territory. We are a rather closely-knit community and small and isolated. And Alexander and Baldwin has always stood for stability and integrity and we felt very strongly that it would be a major disaster, the ramifications of which could not be foreseen, if one of the trust companies went bankrupt and was unable to meet its obligations.

Q. Alexander and Baldwin, Limited, had no financial interest in the Henry Waterhouse Trust Company?      A. No, sir.

Q. At the time this loan was made, the company received a promissory note, did it not, for payment?      A. That's correct.

The Court: Well, that is a note that is set out in the exhibit?

Mr. Pratt: It is in the exhibit, your Honor.

The Court: Exhibit N?

Mr. Pratt: Exhibit N attached to A. and B.'s Exhibit 1.

(Testimony of Arthur L. Dean.)

Q. I show you a note, Dr. Dean. That is the original [309] note, is it not?

A. Yes, sir.

Q. In connection with this loan? Dr. Dean, are you familiar with any other instance such as this where Alexander and Baldwin made an offer to loan money to other institutions at about that time?

A. Yes, sir. The Hawaiian Pineapple Company got in pretty desperate straights and there were rumors that it might go bankrupt, and in our opinion that would be a major disaster of far-reaching consequence in the pineapple industry in which we were interested, and in the total over-all business situation of the Territory. And at that time our directors authorized the management to offer to advance five hundred thousand dollars to Castle and Cooke to help refinance the Hawaiian Pineapple Company.

Q. Was that offer made?

A. That offer was declined because they found they had sufficient resources to handle the reorganization within their own group.

Q. Dr. Dean, with respect to the claim for the deduction of the Hawaii Bureau of Governmental Research, you have read or heard read here in court also the paragraph concerning the stipulation of facts?

A. Yes, sir.

Q. While you were associated with Alexander and Baldwin, [310] Limited, did you have anything to do with the Hawaii Bureau of Governmental Research?

A. Yes, sir.

(Testimony of Arthur L. Dean.)

Q. What did you do?

A. Well, there were two projects, the projects of the Bureau, in which I was particularly concerned. One was the matter of classification of Territorial employees and the setting of salary schedules with respect to which Mr. Goddard conferred with me.

Q. May I interrupt? Who is Mr. Goddard?

A. Mr. Goddard was the director of the Hawaii Bureau of Governmental Research. The other matter had to do with the framing of the two acts which were intended to tie this Territory into the social security legislation of the Federal Government, one the Unemployment Compensation Act and the other the Public Welfare Act. I was chairman, I believe, of the small committee that drafted the original Unemployment Compensation Act. And I also worked with others in connection with the Public Welfare Act.

Q. Now, in your work with that Hawaii Bureau of Governmental Research, who did you represent?

A. Well, strictly speaking of course, I represented Alexander and Baldwin, but indirectly represented the plantation and pineapple companies for which Alexander and Baldwin is agent. That is a very common situation in our organization, where a matter may have comparatively small importance to Alexander and Baldwin itself, but be-

(Testimony of Arthur L. Dean.)

cause of the obligations we assumed as agent for the companies we carry on pretty extensive operations.

Q. Did Alexander and Baldwin, Limited, or its companies reap a benefit by the work of the Hawaii Governmental Research?

A. I believe they did.

Q. In what way?

A. Well, there are two sides to this matter. One is the—you might call the income side, which is related to taxation. And the other the expenditure side, which is related to the efficient expenditure of the funds which are collected by Government through taxation. They are both parts of the same problem, namely, the providing of services through Government for the benefit of the people and the payment by the people for those services. So that whenever the activity of the Bureau impinged either on taxation on the one hand or on Government organization and operation, it had a direct value to all of the taxpayers of the Territory, including Alexander and Baldwin and the companies which it represents.

Mr. Pratt: That's all, your Honor, of this witness.

### Cross-Examination

By Mr. Atherton:

Q. Dr. Dean, do you know whether or not the \$50,000 [312] note was actually paid by the Waterhouse Company?



(Testimony of Arthur L. Dean.)

A. You say, was it paid?

Q. Yes. A. No, sir.

Q. Do you know whether or not Alexander and Baldwin made any formal reply to the communication referred to in the Plaintiff's Exhibit A as Exhibit M, being the copy of the letter dated July 18, 1932, addressed to the taxpayer by the Henry Waterhouse Trust Company, in which it suggested that the Alexander and Baldwin concede the worthlessness of the note by formally authorizing the Waterhouse Company to consider that it is no longer an obligation; do you know whether there was any formal reply made to that letter?

A. No, I do not.

Q. Did you have occasion in 1931, prior to Alexander and Baldwin's making the \$50,000 advance to the Waterhouse Company, to inquire into the financial condition of the Waterhouse Company at that time?

A. I don't remember whether I saw and studied the balance sheet or not. I couldn't tell you.

Q. Did you see a balance sheet of the Waterhouse Company as of February 14, 1931, immediately after the so-called reorganization of that company had taken place?

A. I couldn't answer that categorically. I am reasonably sure that I did but I certainly couldn't testify that I [313] positively, that I did.

Q. Did you form any opinion at that time, February 14, 1931, as to the prospects of repayment

(Testimony of Arthur L. Dean.)

by the Waterhouse Company of the \$50,000 advanced by your company to it?

A. Well, my understanding of it was that the whole situation of the Waterhouse Company was in a state of flux, and that perhaps all that was needed was cash right then and there to take them over the hump. And it wasn't a loan of the type which one would ordinarily make as an investment, trying to make a good investment; that wasn't the kind of an investment that we would have made. But, as I explained in my direct testimony, there were other considerations which made it seem to us worthwhile to make a loan to a company which was, as I say, in a state of flux and about whose future we were by no means sure.

Q. Well, then, you didn't form any opinion at that time, 1931, February 14, 1931, or shortly thereafter, as to the possibility or probability of repayment of that advance?

A. Well, we expected to get all or part of our money back again, but the stake in preserving the company was sufficiently large so that, as I say, we were prepared to make a loan which probably would not have been justified as a straight investment.

Q. In other words, you were more concerned with protecting the Waterhouse Company from becoming bankrupt in 1931 [314] and its possible effect on all the other financial institutions in the Territory than you were about getting repayment of the \$50,000?

(Testimony of Arthur L. Dean.)

A. Well, the basic consideration was the job to be done. As I say, we expected to get money back on our loan, but we took a risk on it.

Q. Now, in 1931, the stipulation discloses in paragraph 25 thereof, that \$25,000 of the \$50,000 advanced to the Waterhouse Company, was charged off on the books of account of Alexander and Baldwin in that year. Will you explain to the Court why you charged off, why your company charged off on its books in the year 1931 twenty-five thousand dollars of that advance?

A. No, I can't do that because I don't know.

Q. The stipulation in the same numbered paragraph also shows that in the following year, 1932, there was charged off \$25,000, being the balance of the \$50,000 so advanced to the Waterhouse Company. Can you explain to the Court why in the year 1932 the \$25,000 was charged off the books?

A. Well, we figured we were in the position of the fellow on the 17th tee with three down.

Q. I'm afraid that doesn't convey any information to me.

A. Well, the point I am making is that you may not have played the thing clear out to the end, but you reach a [315] point when you know that as far as you are concerned you are licked.

Q. Now, in 1932 when your company charged off this \$25,000, what were the facts upon which you concluded that you were partially licked with respect to collecting the note?

(Testimony of Arthur L. Dean.)

A. I don't remember, sir.

Q. So you want the record to show, then, that in 1932 that your company believed it was only partially licked with respect to the collectibility of this note?

Mr. Pratt: Your Honor please, that isn't his testimony.

Q. I am asking you, do you want the record to show that?

The Court: The question is permissible. As I get it, the note as a loss was written off in two amounts, twenty-five thousand in one year and twenty-five thousand in the next year. And the question, as I see it from the testimony, is that they finally determined that they were licked. And the question was, would they determine they were half-licked when they wrote off twenty-five thousand.

Mr. Pratt: But he said in 1932, your Honor. I want to make sure of the year he is talking about.

Mr. Atherton: I am talking about 1932. Read the question.

(The reporter read the last question.) [316]

A. No, sir.

Q. What do you want the record to show?

A. Sir?

Q. What do you want the record to show?

A. That by the end of 1932 we were convinced we were completely licked.

(Testimony of Arthur L. Dean.)

Q. Then will you explain for the Court or to the Court why you only wrote off in that year 1932 one-half of the amount of the note, of the face amount of the note?

A. Doesn't the record show, sir, that the other half was written off the year before or at least the reserve set off to write it off.

Q. Would you say that the charge-off in the prior year, 1931, of one-half of the face amount of that note represented a determination by your company that in the year 1931 it had concluded that only one-half of the note or that one-half of the note had become worthless there?

A. Well, you are calling on me for a conclusion, and all I can say in answer to it is that the officials of the company so determined.

Q. Now, in 1932, Dr. Dean, do you know whether or not, or did you participate in any discussions respecting a contemplated merger of the Waterhouse Company into the Bishop Trust Company?

A. Oh, I knew about it, but I didn't participate in [317] the negotiations or the discussions.

Q. Did you communicate your knowledge of that prospective merger to any other officials or directors of your company in 1932?

A. I couldn't tell you, sir.

Mr. Wild: Just to keep the record straight, your Honor, that wasn't even thought of in 1932. The record shows it didn't come up until 1933.

Mr. Atherton: Your Honor, I'm afraid that Mr.



(Testimony of Arthur L. Dean.)

Wild is out of order. He is attempting to testify.

Mr. Wild: I want to keep the record straight in this case, and we have already stipulated when the merger took place, and counsel is misstating what we have stipulated to.

Mr. Atherton: I'm sorry, your Honor. I am not misstating anything whatsoever. Mr. Wild would like to make it appear that I am making misstatements. I think he should be confined to when he has the floor. The record shows the stipulated fact that the merger took place in 1933; that a letter dated I think some time in December, December 19, 1933—I am not quite sure—was sent out to the noteholders asking them to consider one or two proposals. And they adopted one of the proposals and included the other. What I was trying to bring out through the witness was whether or not prior to 1933 the noteholders had any knowledge of the possibility of a merger. And the very obvious reason of my question [318] goes to this, that if they had knowledge of a prospective merger that was going to take place either that year or a subsequent year, there was reason for them to believe that following the merger of the Waterhouse Company into the Bishop Trust Company that as a matter of law all the liabilities of the Waterhouse Company would be assumed, become obligations of the Bishop Trust Company; and that therefore they had a reasonable basis for believing that after such a merger, if contemplated,

(Testimony of Arthur L. Dean.)

was accomplished that they would be able to collect the face amount of their note.

The Court: Not unless it were realized out of the assets of the Waterhouse Trust Company.

Mr. Atherton: True.

The Court: Well, proceed.

Q. (By Mr. Atherton): Now, coming to the contributions which Alexander and Baldwin made to the Hawaii Bureau of Governmental Research in 1932, will you please state to the Court whether or not your company received any direct benefit as a result of that contribution?

A. I know of no direct benefit, no, in dollars and cents.

Q. Would you say, then, that your company's interest in making that contribution was merely with the expectation, together with all taxpayers, that it might generally benefit as a result of the activity of the Hawaiian Bureau of Governmental Research?

A. Well, in general the Bureau of Governmental Research was not directing its efforts to helping specific companies, you understand, but to more generalized situations. And insofar as they were successful with reference to those, we participated in the success, benefitted thereupon.

Mr. Atherton: That's all. Thank you, Doctor.

The Court: Who, Doctor, organized the Governmental Research and sold the idea to the business community, do you know?

(Testimony of Arthur L. Dean.)

The Witness: You say, who did it?

The Court: What?

The Witness: Did you ask who did it?

The Court: Yes.

The Witness: I don't remember the names of the individuals. They are probably of record.

The Court: You don't remember how it came about that it was organized?

The Witness: I think it was talked up in a comparatively small group at first, and other persons were interested until there were enough of them interested to put up enough money to get the thing launched.

The Court: All right.

Q. (By Mr. Pratt): Dr. Dean, in connection with your cross-examination on [320] these contributions, Governmental Research, you say that any benefits that you got would be proportionate to your contribution? The stipulation, Dr. Dean, shows that the contributions were made according to the amount of taxes that the various contributors put in. In some instances, of course, they did give more or less than that. That was the plan.

Mr. Atherton: Your Honor, I think that question is objectionable. It calls for a conclusion from the witness. He has already testified that they received no direct benefit.

Mr. Pratt: It doesn't have to be direct, your Honor, in our interpretation of the cases. Also, the Government's own position more recently—

(Testimony of Arthur L. Dean.)

The Court: I just lost track of the exact wording of the question.

(The reporter read the last question.)

The Court: Well, I don't get what the question was.

Mr. Pratt: It's at the very beginning, your Honor. My question was, I asked him whether the benefits that they got, which they received, were proportionate to their contributions.

The Court: Oh, if you can answer that, you may.

The Witness: I don't think I can, your Honor.

The Court: All right.

Mr. Pratt: I have no other questions.

(Witness excused.) [321]

Mr. Pratt: Does the Court desire to start on our last witness?

The Court: I think so. He will be a short witness, I take it.

Mr. Pratt: I think so.

### CARL R. LINDEN

a witness in behalf of Alexander and Baldwin, Limited, being duly sworn, testified as follows:

#### Direct Examination

By Mr. Pratt:

Q. Will you state your name?

A. Carl R. Linden, L-i-n-d-e-n.

(Testimony of Carl R. Linden.)

Mr. Pratt: I might state to the Court and Counsel that Mr. Linden is hard of hearing, and if I talk loudly the Court will understand.

The Court: Yes.

Q. You reside in Honolulu, Mr. Linden?

A. I do, yes, sir.

Q. And how long have you lived here?

A. Since 1919.

Q. And you are connected with Alexander and Baldwin, Limited?      A. I am.

Q. And how long have you been so connected?

A. Since April, 1920. [322]

Q. Did you at any time have any connection with American Factors?      A. Yes.

Q. In what capacity?

A. From 1920, from April, 1920, until the end of 1935, to the best of my recollection.

Q. And what was that connection?

A. I was tax advisor and giving certain advice in connection with accounting procedure.

Q. And you have a similar position with Alexander and Baldwin?

A. I have, and still have.

Q. And you have had that how long?

A. For 27, going on 28 years now.

Q. In connection with the Henry Waterhouse Trust Company matter, which is now before the Court, you have read the stipulation filed, have you not?      A. I have, yes, sir.

Q. And did you have any connection with the



(Testimony of **Carl R. Linden.**)

matter of claiming any tax deduction with respect to the loan to Henry Waterhouse Trust Company?

A. That was my job.

Q. And did you also have anything to do with it for American Factors?      A. Yes, sir. [323]

Q. In this stipulation, Mr. Linden, reference is made to the fact that Alexander and Baldwin is on a cash basis, and the Court desired to have some brief statement as to what was meant by cash basis. Would you state that?

A. That means that the transaction is not recorded until it is closed. In other words, take as an illustration, you have a bond that the interest, the dates we will say, the interest dates are September and March. On December 31st there are three months' interest accrued on that bond. In the case of an accrual where your books are kept on the accrual basis, that interest would then be taken up as part of that year's income; whereas, on the cash basis it is not taken up as income until the coupon is clipped or the interest is paid. If it is never paid, it is never taken up. That is the distinction between the cash and the accrual method of accounting. Cash method is used primarily by concerns like ours and by banks where there are no inventories or trading involved, where in the merchandising business you can't be on a cash basis because you buy goods and you carry them over from year to year.

Q. Mr. Linden, in paragraph 25 of the stipula-

(Testimony of Carl R. Linden.)

tion in evidence as A. and B. Exhibit A, I'd like to show you the items which are shown as being book entries in the year 1931, December 31, and August 8, 1932. Are you familiar with those entries? [324]

A. Yes, sir. These entries were taken from the books of original entry.

Q. And with respect to the entry for the year 1931, what have you to say with respect to that?

A. At the end of 1931 the treasurer of the company asked me if it would be all right to write down half of it, and I asked him the reason for it. He said, we had a good year. I asked him what evidence or information he had. Well, they didn't have any. I said, well, write it off, but you can't claim it is a tax deduction. So he wrote it off. And on the back of the return he made, the schedule, it is shown as a non-deductible item.

Q. I show you your office copy of return for the calendar year 1931, and refer you particularly to schedule "L," and ask you if anything is indicated there as to what disposition was made of this 1931 item?

A. Under item 13-J it is shown as reserve loss, \$25,000, which indicates or shows that it was not taken as a deduction.

Q. That \$25,000 mentioned there was the Henry Waterhouse Trust Company obligation?

A. That was the one-half that is shown in your stipulation you just showed me. That is written off on December 31, December, 1931.

(Testimony of Carl R. Linden.)

Q. And your return indicated that it was put in the reserve for loss. In the year 1932 what was done with respect [325] to the Henry Waterhouse Trust Company note?

A. The remaining \$25,000 were written off, and when we came to prepare the tax return for that year the whole amount was claimed as the deduction for bad loss.

Q. And what, if anything, did you do at that time to ascertain whether it should be written off or not?

A. Well, in the first place I took it up to Mr. Lowrey, Sherwood Lowrey, who was treasurer at that time of the American Factors. And being interested in both Alexander and Baldwin and the Factors, and having both treated the same way, we discussed it and he was on the committee, to the best of my recollection, the Waterhouse committee, to make an appraisal to ascertain the progress of the liquidation; and he was firmly of the opinion that there was no possibility of any recovery ever being made from it, from that note.

Q. Did you also have occasion to discuss the matter with Mr. John Waterhouse.

A. Oh, yes.

Q. And did he express a similar opinion?

A. He did. He said from all the reports it is lost, gone.

Q. And who is Mr. John Waterhouse?

A. He was president and general manager of Alexander and Baldwin, Limited.

(Testimony of Carl R. Linden.)

Q. And do you know whether or not he was also connected [326] with the Bishop Bank?

A. I am quite certain he was on the board of directors at that time.

Q. He subsequently became president?

A. He became president after George Rea resigned as the executive vice-president and manager.

Q. I show you a copy of the 1932 return, Mr. Linden, and also ask you to look at schedule "L" and state whether or not there is anything shown there with respect to the 1931 item?

A. Under item 4-C of the return as shown, which is on the lefthand or debit side, is shown reserve for loss, 1931, \$25,000.

Q. What was the purpose of putting that in there?

A. That was merely a reversal of a similar adjustment on the other side of the previous year's return to show that that \$25,000 was included among the deductions on this return.

Q. So that you not only wrote off on this return the deduction shown in the ledger for '32 but also the one for '31?      A. That's correct.

Q. Mr. Linden, I show you the original of Exhibit "M" attached to A. and B. Exhibit A, the letter of July 18, 1932, and ask you whether you saw that letter?

A. Yes, I have seen that before. [327]

(Testimony of Carl R. Linden.)

Q. And you know whether or not that letter was received prior or after Alexander and Baldwin had written off the obligation?

A. It was received several months prior to it, of course. It was received, it's got the receiving stamp of July 18, 1932.

Q. And, Mr. Linden, the book entry in paragraph 25 refers to the write-off as having been made on August 8th. Do you know whether or not any reference was made to this letter in that book entry?

A. Yes, there was a notation made in the explanatory journal entry which referred to this letter.

Q. That reference in here this paragraph 25 referred to a letter, H. W. Company, 7/18/32. That is this letter?      A. That is this letter.

Q. And following your examination of this letter, did you have any discussion of its contents, particularly the references to the fact that the note was worthless, with anybody?

A. I talked it over with Mr. Lowrey.

Q. And it was that conversation that you previously reported?

A. That is the conversation which I previously reported and which prompted us to claim it as a loss in 1932. [328]

Q. Do you know anything concerning the Hawaii Bureau of Governmental Research?

A. In a general way.



(Testimony of Carl R. Linden.)

Q. And did you have anything to do with the claim of deduction? A. Yes.

Q. And what prompted you to make that claim?

A. Because that contribution was made towards the conduct of an organization whose business it was to examine into Governmental expenditures and see that taxpayers got dollar's worth of service for a dollar's worth of taxes paid. And Alexander and Baldwin in itself had among other things between 40 and 50 million dollars worth of taxable property subject to real, personal property taxes in addition to their income taxes, and we would not have served our clients properly unless we contributed towards the support of an organization of that kind. So I couldn't see that there could be any objection at all to taking it as a deduction.

Mr. Pratt: I think that's all, your Honor.

#### Cross-Examination

By Mr. Atherton:

Q. Mr. Linden, did your company adopt the actual method for charging off bad debts or the reserve method for charging off bad debts?

A. During the 27, going on 28 years, that I have been [329] with the company, that is the only occasion I can recollect where we ever had any bad debts. We kept pretty clean records down there.

Mr. Wild: No experience.

The Court: Never took another chance?

(Testimony of Carl R. Linden.)

The Witness: No, sir. If you get anything out of what you have got, you have got to be good.

Q. So, then, in 1931, as I understand from your testimony, this was the first year in which your company had any reason to consider any of its accounts and notes receivable, bills receivable and what have you, as possibly being uncollectible?

A. To the best of my recollection. That is a long time ago, and my memory is not any too long.

Q. Then in 1931, you have testified that in that year your accountant charged to a reserve for loss \$25,000 of the face amount of the Waterhouse note?

A. That is not entirely correct. He charged direct to profit and loss but the intent was that they should be—he had us instructed to charge it to a reserve for bad debt but didn't truly do it. We treated it as a reserve in the tax books but on the reserve it is charged to profit and loss.

Q. So that then for accounting purposes you adopted the actual method of charging off bad debts rather than the reserve method? [330]

A. Well, we, as I testified before, we never had occasion to use any reserves at all. We never had any reserve for bad debts on our books as long as I have been with the firm.

Q. What were the circumstances that motivated your company in charging off in the year 1931 only 50 percent of the face amount of the Waterhouse note?

A. Well, sir, to the best of my recollection the

(Testimony of Carl R. Linden.)

excuse given by the treasurer was, we had a good year and he wanted to be conservative.

Q. I notice also on the return for the taxable year 1931 of Alexander and Baldwin, under schedule "L" thereof is shown an item of \$17,500 as a reserve for taxes.

A. Yes. That is probably capital stock taxes. We can tell better on here.

Q. Well, I am not curious about what it is. Also up here under the charges against reserve for contingencies, and so forth, there is shown an item of \$9,762.58.

A. Correct.

Q. Charged off to a reserve for Territorial income tax paid from the reserve.

A. These reserves for taxes were set up primarily for purposes of showing the amount of money or earnings available for dividends. We actually took in the return the taxes that we paid during the year. These reserves did not enter into [331] our income for tax calculations.

Q. All right. Now, you testified that the accounts of Alexander and Baldwin, Limited, for the taxable years, for the calendar years 1931 and 1932, and I believe for all prior years, are kept on the cash receipts and disbursements basis?

A. Yes.

Q. Now, I would ask you to examine the balance sheets for the calendar year 1931, annexed to the corporations Federal income tax return for that year, and explain to the Court, then, if the accounts or the method of accounting as the cash basis of

(Testimony of Carl R. Linden.)

accounting, why they are shown on the balance sheets as reserve?

A. They are shown there reserved for depreciation.

Q. For taxation?

A. That's right, taxes. And that is a misnomer. That is not—you can't reserve a fund.

Q. And the reserve for employees benefit fund, the \$135,910.08, as of December 31, 1930, and the balance sheet shows as of December 31, 1931 the amount of \$141,125.23 carried in a reserve for employees benefit fund. Now, if the corporation is on a cash basis, will you explain to the Court please why that is carried as a liability?

A. If you will look on the assets side you will find an identical figure there. Those are just offsetting items, [332] practically so. The purpose of the employees benefit fund which was created a good many years ago was to provide a fund out of which doctors' bills and other charges like that of employees who were not able to carry them would be paid; and also to advance money to employees who wanted to buy their own homes. And so way back before my time some money, some hundred odd thousand dollars were appropriated and set aside which the management was permitted to loan to employees and utilized for purposes of paying medical expenses of themselves and families. That is the low-bracket employees. I don't get it.

Q. Now, will you read in to the record what the

(Testimony of Carl R. Linden.)

balance sheet as of December 30, 1931, shows on the asset side as the amount in the employees benefit fund?

A. There are \$134,840.22, and on the other side—

Q. What does the liability side show?

A. The liability side shows \$135,910.08.

Q. Now, as of December 31, 1931, will you please—

Mr. Pratt: If your Honor please, may I at this stage of the questioning object to further examination? Counsel has stipulated that the company is on a cash basis. I don't know what the purpose of this examination is.

The Court: Well, I don't either, and therefore I don't feel disposed to rule on it now, on the examination. Is there much more of this? [333]

Mr. Atherton: Well, I was trying to develop if they are on the cash basis, your Honor. Then why did they charge this? Why they carried this reserve here, your Honor?

The Court: Well, you are trying to find out whether they were really on a cash basis all the way through or just at convenience?

Mr. Atherton: That's right.

The Court: All right, go ahead.

A. I have never heard of any objection to having reserve in case where books are kept on the cash basis, and I have been an accountant for over 40 years.

Q. Would you say, then, Mr. Linden, that the



(Testimony of Carl R. Linden.)

method of accounting of this corporation was more of a hybrid method—— A. No, sir.

Q. ——than strictly cash method?

A. No, we are strictly on the cash basis.

Q. As to the contribution made of a thousand dollars to the Hawaiian Bureau of Research, did the taxpayer receive any direct benefit from that contribution?

A. If you mean by direct benefit that we can show in dollars and cents, how much we received, that would be no more possible to do that than it would to tell how much benefit you get by going to a dentist and having a tooth filled. But if we hadn't received benefits from it, we wouldn't have paid it in the first place. It was a very efficient organization, [334] that in every problem of Territorial administration there was and locally, and gave us periodical reports, and at least they claimed that they were instrumental in reducing unessential expenditures and conversely taxes by their activity.

Q. You testified, Mr. Linden, that you made this contribution a sort of duty-bound to your clients or those companies that you represented?

A. That's right.

Q. Do you know whether or not they likewise made contributions to this fund?

A. I am not prepared to answer that because I have not had occasion to look it up.

Q. Do you know whether or not any of them

(Testimony of Carl R. Linden.)

received direct benefits as a result of the activity of the Bureau?

A. We did it for their benefit. Our contributions were for the benefit of our clients so far as we ourselves are concerned. Our taxes, you might say, are nominal.

Mr. Atherton: Very well. Thank you.

(Witness excused.)

The Court: We will take a recess now until 1:45.

(The Court recessed at 12:20 p.m.) [335]

#### Afternoon Session

The Clerk: Civil No. 419, American Factors, Limited, versus Fred H. Kanne, for further trial.

The Court: You may proceed.

Mr. Wild: I would like to have Exhibit P-13, if I may have it. I'd like to call your Honor's attention and read Plaintiff's Exhibit P-13, except for the details according to the schedules. It is headed as Bank Examiner's Report of the condition of Henry Waterhouse Trust Company, Limited, Honolulu, T. H., at the close of business December 31, 1932. And then an official cover of the Territory of Hawaii.

"Bank Examiner's Report of the Condition of Henry Waterhouse Trust Company, Limited, Honolulu, T. H., at the close of business December 31, 1932.

“A copy of this report of examination is furnished to the Board of Directors of the examined institution for their information and consideration. The information contained herein is based upon the records and books of the institution and upon statements made to the Examiner by officers and employees, and on data secured from other sources believed to be reliable, and presumed by the Examiner to be correct.

“Much of the information in regard to the assets of the institution is of such a character as to make it necessary for the Examiner to rely upon the good faith and assurances of his informants, and while the Examiner regards the statements [336] so accepted by him as correct, he is, necessarily, not in a position to guarantee the accuracy of such part of the information as may not have been obtained at first hand.”

That is the usual printed form, your Honor. Then it names the officers and directors, which I will omit.

“To the Stockholders and Directors,  
Henry Waterhouse Trust Company, Limited,  
Honolulu, T. H.  
Gentlemen:

“We have completed an examination of the condition and affairs of the Henry Waterhouse Trust Company, Limited, as at December 31, 1932, and common thereon as under.

“Various analysis and schedules in the form of exhibits have been prepared from the records and

books of the company to present its financial position as at December 31, 1932. Much of the information in regard to the assets of the company is of such character as to make it necessary for the Examiner to rely upon the good faith and assurances of his informants, and while the Examiner regards the statements so accepted by him as correct, he is, necessarily, not in a position to guarantee the accuracy of such part of the information as may not have been obtained at first hand.

“The records of the Henry Waterhouse Trust Company, Limited, show that subsequent to February 14, 1931, and [337] shortly after the company was taken over by the Bishop Trust Company, Limited, sufficient assets appeared to be on hand to meet all liabilities of the company. See Auditor’s Report of February 14, 1931. An analysis of the various asset and liability accounts of the company made by us as at December 31, 1932, disclosed, according to our figures, an insufficient amount of assets to meet the remaining liabilities. We have prepared and submit herewith Exhibit ‘B’ of the analysis made.”

Would it be helpful to your Honor to follow a copy of this? I have a copy.

The Court: As to the figures?

Mr. Wild: Yes.

The Court: Yes, you may pass me a copy.

Mr. Wild: I am reading now from the third paragraph. “We have prepared and submit herewith Exhibit ‘B’ of the analysis made. Contingent

reserve and capital are entirely absorbed and Bishop Trust Company, Limited, advances to an amount of \$255,215.61 were used to meet estimated losses."

The Court: Which sheet is this?

Mr. Wild: You mean what I am reading? It is from the third paragraph, your Honor, in the letter.

The Court: Yes. I wasn't so much interested in that.

Mr. Wild: Oh, it is the sheet "B" as annexed.

The Court: Page four? [338]

Mr. Wild: I think it is this one. Isn't that sheet "B"?

The Court: Page five. Oh, yes, that's right.

Mr. Wild: "Contingent reserve and capital are entirely absorbed and Bishop Trust Company, Limited, advances to an amount of \$255,215.61 were used to meet estimated losses.

"The policy of the Bishop Trust Company, Limited, in the future with respect to the application of assets to pay liabilities should be to assign cash, real estate mortgage loans and participation in large real estate mortgage loans to respective individual fiduciary, trust and deposits credit balances. Large real estate mortgage loans suitable for trust investments should be reappraised, renewed and arranged to permit the issue of participation certificates thereon. As the payments on account of loans assigned are received the respective fiduciary, trust or deposit accounts should receive the benefit thereof. Pursuit of this policy should, in time, liquidate all individual fiduciary, trust and deposit liability accounts.



“The cash thus accumulated should be deposited in a special bank account and not kept with or made a part of the general funds of the Henry Waterhouse Trust Company, Limited, or its affiliates.

“The Henry Waterhouse Trust Company, Limited, because of its insolvent condition, cannot carry on a business. Whatever business is required to be transacted should be done [339] by the Bishop Trust Company, Limited.

“Every effort should be made by the Bishop Trust Company, Limited, to maintain this policy. Unusual demands for cash withdrawals by clients, the payment of which cannot be avoided, should be met from general funds on hand or from funds advanced by the Bishop Trust Company, Limited, but not from the accumulated funds of other clients.

“Assets in the form of stocks, bonds, loans, advances, receivables, real estate owned and other of doubtful value or that cannot readily be applied to a liability or liabilities should be assumed by the Bishop Trust Company, Limited, who assumed the ultimate liability, if any, of the Henry Waterhouse Trust Company, Limited, as stated in letter of March 14, 1931, of the Bishop Trust Company, Limited, to Hon. E. S. Smith, Treasurer of the Territory of Hawaii, and as set forth in paragraph 4 of letter dated February 24, 1931, sent to each of the contributors for the \$400,000.00 Special Reserve which reads: ‘The Bishop Trust Company, Limited, will ultimately contribute such amount, if any, over the above sum of \$1,035,000.00 as may

be required to liquidate the liabilities of the Henry Waterhouse Trust Company, Limited.'

"You are requested to fully analyze all investments held in your trust and estates portfolios to determine the soundness of such investments and their qualification for trust and [340] estate investments. Any investment found unqualified or that there is a possibility that they will not be accepted by the courts you will remove and replace with other qualified investments.

"You are also requested to follow the procedure for the future conduct of the affairs of the Henry Waterhouse Trust Company, Limited, outlined above.

"Losses should be written off as they occur or as they become evident; we refer particularly to the J. P. Looney real estate mortgage loan and the old trust and agency debit balance accounts now on the books which were eliminated when the properties of J. P. Looney were acquired thru foreclosure sale, and the old fire and old life insurance premium accounts deemed uncollectable.

"Attached hereto and made a part of the comments are the following exhibits and schedules applicable as at December 31, 1932."

Then as Exhibit "A" the balance sheet; Exhibit "B," analysis of assets and liabilities; Exhibit "C," analysis of real estate mortgage, collateral and unsecured loans. Then there is Schedule 1, stocks and bonds pledged as security for loan from Bishop First National Bank of Honolulu, and the other

schedules which I don't care to read because they are the detailed schedules of which the first is the summary.

Then Exhibit "A" shows—well, it says, "Examiner's [341] Report of Condition of the Henry Waterhouse Trust Company, Limited, Examination commenced at 1:00 p.m., January 11, 1933, and 8:00 a.m., March 4, 1933; closed at 4:00 p.m., January 29, 1933, and closed at 4:00 p.m., May 16, 1933. Made by Geo. Theurer, Examiner-in-Charge, and Assistant T. A. Lyons."

Exhibit "A" shows resources: Cash on hand and in banks, \$14,639.50; stocks and bonds, \$267,122.42; stock of affiliated companies, P. E. R. Strauch, Ltd., \$293,704.16, Kaimuki Land Co. \$10,000.00. The total, \$303,704.16. Advances to affiliated companies, P. E. R. Strauch, Ltd. \$114,000.00, Kaimuki Land Co., Ltd. \$40,787.92, which makes a total of \$154,787.92. Receivables: Life insurance accounts, \$9,530.80, life insurance notes \$5,683.89, T & A general accounts \$42,798.86, and T & A petty accounts \$256,766.46, or a total of \$314,780.01. Loans: real estate mortgages, \$839,524.74; collateral, \$934,563.61; unsecured, \$10,651.77. The total, \$1,784,740.12. Real estate owned: Pacific Heights, \$20,000.00; Horner property, \$149,700.00; Looney property, \$63,573.02. The total, \$235,273.02. Other assets: stock exchange seat, \$10,000.00; furniture and fixtures, \$6,119.16; automobiles, \$1,207.50. Total, \$17,326.66. Real estate held in trust, \$92,500.00. Offset by note to Bank of Hawaii, \$92,500.00. Sus-

pense: operating and management, \$17,500.00. Total, \$3,107,873.81. [342]

Liabilities: Brokers: Russel Miller & Co., \$23,-601.77; Goodbody & Co., \$21,580.93; total \$45,182.70. Notes payable, \$674,190.88. Bishop Trust Company advances, \$585,000.00. Trust and Agency accounts: general accounts, \$685,245.04; depositors accounts, \$383,662.24; total, \$1,068,907.28. Pledged to clients: real estate loans, \$132,128.00. Merchandise account, \$1,458.44. Suspense account: Bishop Trust Co. \$17,500.00; Mizushima Commission, \$2,417.13; tax on drafts and checks, \$6.96. Total, \$19,924.09.

The Court: Total what?

Mr. Wild: The total of these suspense account items.

The Court: How much?

Mr. Wild: \$19,924.09.

The Court: Yes.

Mr. Wild: Then the total of all above is \$2,526,-791.39. Then contingent reserve: for losses, \$271,-294.27; underwriters, \$400,000.00. Total of those items, \$671,294.27. Loss of \$490,211.85. Balance, \$181,082.42. Capital stock, \$400,000. The total of the liability figure is \$3,107,873.81.

Now, in Exhibit "B", analysis of assets and liabilities as of December 31, 1932. The assets show the summary and at the bottom in the lower right-hand corner I call Your Honor's attention to "No Value", Donations Capital \$400,000.00 Nil, Contingent Reserves \$181,082.42 Nil. And it shows a deficit of \$255,215.61. [343]

The Court: That is after the donations are written off?

Mr. Wild: Yes, Your Honor. In other words, this statement, Exhibit "B", shows that after the \$400,000 donations are out of the picture, Bishop Trust Company, Limited, will sustain losses of \$255,215.61 on account of its guarantee.

The Court: These were pretty drastic revaluations, weren't they?

Mr. Wild: Yes, Your Honor.

The Court: Well, they were almost of a panicky nature, weren't they?

Mr. Wild: No, you wouldn't have seen anything yet, because it goes on with a pile-up of other losses. We were really going into the turmoil of the depression, as Mr. Castle testified this morning. This is an independent examination by the bank examiner's office, from all sources.

The Court: Were these book assets prior to this revaluation—they had already been revalued and sustained quite a very substantial depreciative value, didn't they?

Mr. Wild: Yes, Your Honor. But as Your Honor will remember, that was the day when assets in '32, asset values were dropping. I think Radio Corporation stock would go down from fantastic amounts to a very few dollars. And that is what happened here. This bank examiner's report shows the plunge that was made in values, Hawaii following the mainland.

The Court: Was there such a drop in bond val-



ues from [344] fifty-seven thousand odd dollars down to fifteen odd thousand dollars?

Mr. Wild: Well, Your Honor, the bond values——

The Court: About 70 odd percent depreciation in bond values?

Mr. Wild: Yes. Schedule 2, stocks and bonds—— which item is it there that you are reading from?

The Court: I am reading from the stocks and bonds in this Exhibit “B”. I was looking at the estimated loss requiring reserves, fifteen thousand dollars loss.

Mr. Wild: The schedule which isn’t there shows the items of those. It shows these different valuations made at market. It shows each item in that valuation, and how many shares or how many bonds there were, what the book value was, and what the then market value was. Those have gone into exhaustive detail, Your Honor, showing the picture as these gentlemen saw it at this time, and they were an independent value.

The Court: Well, they weren’t actually put on the market and sold at those values, were they?

Mr. Wild: No, unfortunately.

The Court: Unfortunately?

Mr. Wild: Yes, because they were sold at even a lesser value, many of them, later.

The Court: Yes. All right. [345]

Mr. Wild: Each year thereafter, if we want to go into it, would show an increasing——

The Court: I have no occasion to go in and criticize figures of that sort.

Mr. Atherton: Your Honor, can I ask a question? Has this exhibit been admitted in evidence?

Mr. Wild: Oh, yes, P-13.

Mr. Atherton: Was it admitted?

The Court: Yes, I understand it was admitted.

Mr. Atherton: The whole report was admitted?

The Court: The whole report. Your objection was to the admission of a portion of the report without putting all of it.

Mr. Atherton: I guess it is too late for me now to hand an objection to the full report. I would like to——

Mr. Wild: Well, he planned the whole report.

Mr. Atherton: What I recollect was that I said if any part, the whole report should go in, but I don't know whether the record will show that I objected, that I raised no objection—if it is not too late now I would like to object to the admission in evidence of the whole report or any part thereof on the ground it is immaterial and irrelevant.

The Court: Immaterial and irrelevant?

Mr. Atherton: I will tell you why. Because the report as made on the face of it purports to have been an examination [346] conducted during the year 1933. And the report was dated July 20, 1933.

The Court: Well, you should have pointed that out to the Court at the time the matter was under discussion earlier. I got the impression that the only objection you had to it, to the offer, was to

excerpts of the report, and that if anything in connection with the report was to be offered that you wanted the whole report in. That was the impression I got.

Mr. Atherton: Yes, that was the way I felt about it. I don't know that I made myself clear, and I know I should have made myself more clear. The whole thing took me by surprise.

The Court: I don't feel disposed now, after all this time, to strike it from the record. But the Court will keep in mind that this report was made in '33 after the former transactions of writing off the bad debit.

Mr. Wild: The other supporting schedules which I won't call attention to here are along the same lines, Your Honor. It shows how they have written down the various ones. And the report, I might state, although actually made after the year, was made for the calendar year 1932. Those dates went in this morning, Your Honor. And it shows in the first page of the report itself that immediately after the end of the year '32 the bank examiner's office started work, and they [347] couldn't very well until they had the '32 accounts in, Your Honor. We have no further evidence at this time. I haven't read a number of our exhibits in toto, but I take it that our failure to read them in toto doesn't mean that we can't refer to them in arguments or briefs.

The Court: All right.

Mr. Pratt: We have no other evidence, Your Honor.

The Court: Both parties plaintiff close?

Mr. Atherton: Now, for the Government, Your Honor, I'd like to offer in evidence—I'd like to mark it for identification in the Alexander and Baldwin case, as the Government's exhibit, Defendant's Exhibit No. 1, a certified photostatic copy of the Federal income tax return of Alexander and Baldwin, Limited, for the calendar year 1932.

The Court: Tax return for the year 1932? We have no exhibit 1 as yet?

The Clerk: No.

The Court: We will call that Exhibit 1.

Mr. Wild: Might that be marked Defendant's 1, that is, in the A. and B. case?

Mr. Atherton: No objection.

Mr. Pratt: No objection.

Mr. Atherton: Then I offer it in evidence as Defendant's Exhibit 1 in the Alexander and Baldwin case.

(The document referred to was received in evidence as [348] Defendant's Exhibit 1 in the Alexander & Baldwin case.)

Mr. Atherton: Then I'd like to have marked for identification a certified photostatic copy of the Commissioner's 90-day deficiency letter dated June 2, 1936, addressed to Alexander and Baldwin, Limited, with respect to the tax year 1932. I'd like that to be identified as Defendant's Exhibit No. 2 in the A. and B. case.

Mr. Pratt: No objection.

Mr. Atherton: There being no objection interposed, I offer that in evidence as Defendant's Exhibit 2.

The Court: I understand now both of these documents are accepted in evidence, and not merely for identification.

(The document referred to was received in evidence as Defendant's Exhibit 2 in the Alexander & Baldwin case.)

Mr. Atherton: Then I'd like to identify—well, I will offer in evidence as Defendant's No. 3, a certified copy of the claim for refund filed by Alexander and Baldwin, Limited, for \$8,853.06, Federal income tax alleged to have been overpaid for the calendar year 1932.

The Court: What is the date?

Mr. Atherton: The amount is \$8,853.06.

The Court: I say, the date?

Mr. Atherton: Oh, the date of the claim? The date shown on here appears to be December 15, 1936, that it was filed.

(The document referred to was received in evidence as Defendant's Exhibit No. 3 in the Alexander & Baldwin case.) [349]

The Court: Yes. All right.

Mr. Atherton: No, I am sorry, it is earlier than that. November 27, 1936, Your Honor. It is a mistake.

Mr. Cades: Shouldn't that be lettered A, B and C instead of numbers?



Mr. Pratt: They are in the other case, Your Honor. Our case number is 474. And I think if it is in that case, it wouldn't be mixed up with this.

The Court: Well, I've got this all under the matter of A and B's case.

Mr. Wild: Mr. Cades was referring to this, Your Honor. I thought in our case that if we numbered the plaintiff's exhibits and called them "P" and by number, then the Government's A, B, C and D. We could differentiate easily between the exhibits adduced on testimony and those attached to stipulations.

The Court: We can do that very well when we get to it. Now we are taking these A and B's as 1, 2 and 3. We will take yours as A, B and C.

Mr. Wild: Yes.

Mr. Atherton: I would like to offer in evidence a certified photostatic copy of Deputy Commissioner's letter dated November 14, 1940, notifying Alexander and Baldwin, Limited, of the objection in its entirety of its claim for refund of \$2,941.90 and \$8,853.06 Federal income taxes for [351] the years 1931 and 1932, respectively.

The Court: Received in evidence. Both bound together, are they?

Mr. Atherton: There is only one letter.

The Court: As Exhibit 4.

(The document referred to was received in evidence as Defendant's Exhibit No. 4 in the Alexander & Baldwin case.)

The Court: What is the date of that letter?

The Clerk: November 14, 1930.

Mr. Atherton: Forty.

The Clerk: Forty, is it? I can't read it.

Mr. Atherton: That concludes the Government's evidence in the Alexander and Baldwin case, Your Honor.

The Court: Yes.

Mr. Atherton: Now, with respect to the case of the American Factors, Limited, the Defendant would like to offer in evidence the Commissioner's 90-day deficiency letter dated September 3, 1937, addressed to the American Factors, Limited.

The Court: Thirty-seven, December 3, 1937?

Mr. Atherton: Yes, Your Honor.

Mr. Wild: September, wasn't it?

Mr. Atherton: September 3, 1937, addressed to American Factors, Limited, wherein the Commissioner made an original determination of a deficiency for the calendar year ended December 31, 1932, of \$62,438.82. [351]

The Court: Sixty-two thousand?

Mr. Atherton: Four hundred thirty-eight dollars and eighty-two cents, in income tax for that year. Any objection?

Mr. Wild: Yes, Your Honor. I will object to that as incompetent, irrelevant and immaterial. We have answered that deficiency letter in our claim for refund and it hasn't been denied. And there is also other evidence in the case, and the statement can only be used there in the event there isn't any other evidence. That is just my objection.

The Court: Let me get that now. The objection to this letter is that you have answered it in——

Mr. Wild: I have answered the allegations of fact made in that letter, and the law, in my claim for refund. And my claim for refund has not been denied. It was annexed to the complaint. And that therefore this letter can be of no probative value, for any of the facts therein stated.

The Court: Well, for nothing more perhaps than calling the Court's attention to it.

Mr. Wild: Very well.

Mr. Atherton: No, Your Honor, this letter represents an official determination by the Commissioner of Internal Revenue of a deficiency for the taxable year 1932. And when the Commissioner makes a determination of a deficiency the burden is upon the taxpayer to overcome that determination, to show that it is in error. The Commissioner's determination is [352] *prima facie* correct. Now, we will show at the proper time, unless you wish to do it now, that the Government's answer, the Defendant's answer to the complaint in this particular case did deny in effect or did not—no, that the allegations in the complaint with respect to the claim for refund did not require any responsive pleading in that they merely allege that a claim for refund, a copy of which was annexed to the complaint, was filed giving the date of filing. Now, under those circumstances the Defendant's contention is that that type of an allegation required no responsive pleading because there was no issue of

the fact of the claim for refund that was filed. There was no intention, nothing in the allegations that incorporated by reference the so-called allegations of fact made in the claim for refund that would require responsive pleading by the Defendant to that allegation.

And for the Court's information, let's turn to the complaint. Paragraph 23 of the complaint states:

"That on or about April 5, 1938, Plaintiff filed with the Commissioner of Internal Revenue through the Collector of Internal Revenue, his agent for that purpose, a claim for refund (a copy of which is attached hereto and marked Exhibit 'A') covering the calendar year 1932 on Form 843, as prescribed by the Commissioner of Internal Revenue, for the refund of said \$80,254.41, which claim was rejected by the Commissioner [353] on or about December 2, 1938."

Now, as I understand the Plaintiff's contention, that because in the answer the Defendant failed to either admit or deny that allegation that thereby it was tantamount to an admission of all the allegations of fact contained in the claim for refund. And I think that is a preposterous proposal to make to this Court. It is absolutely ridiculous. And when you come to paragraph 26 of the complaint, it reads this way:

"That on or about December 22, 1938, Plaintiff filed with the Commissioner of Internal Revenue through the Collector of Internal Revenue, his agent for that purpose, a claim for refund (a copy of

which is attached hereto and marked Exhibit 'B') on form 843, as prescribed by the Commissioner of Internal Revenue, for the additional amount of \$16,880.49 so paid by Plaintiff to Defendant on October 26, 1938; that more than six months have elapsed since the filing of said claim and the Commissioner has neither accepted nor rejected the same."

Now, certainly, Your Honor, this failure to specifically deny or admit that allegation doesn't admit the allegations of fact set forth in detail in the claim for refund. There is no substance to the Plaintiff's——

The Court: Do you want to be heard on that?

Mr. Wild: Oh, yes, Your Honor. In legal proceedings [354] rules applicable to pleadings are binding alike upon the Court and counsel, as I apprehend it. The United States had just adopted the Rules of Civil Procedure for its District Courts, and in those rules they prescribed the forms of pleadings and what the reference to a written instrument meant. And in 10(c) of those rules it states in part as follows: "Adoption by Reference; Exhibits. A copy of any written instrument which is an exhibit . . ." And this is an exhibit to a pleading. " . . . which is an exhibit to a pleading is a part thereof for all purposes."

In other words, when I just annex that, that this is a true copy, that makes that written instrument by virtue of the law a part of that pleading for all purposes, meaning that every allegation that is in



there is an allegation of fact which requires either responsive answer or, if you don't file a responsive answer to it, you admit it.

Now, that precise point has been up before the Court, Your Honor. In the case of Peoples Natural Gas Company versus Federal Power Commission, 1942, 127 Federal 2nd 153, the Federal Power Commission made a motion to compel the Gas Company to allow the Commission access to the company's books and records. The motion filed by the Commission in the District Court did not allege any facts showing the Commission had jurisdiction to demand the books and records. In an exhibit attached to the motion, just like our exhibit [355] is attached to the complaint, the Commission stated that the Company sold gas at its station in Pennsylvania to an affiliated company in New York. The answer of the company filed denied that it is a natural gas company within the meaning of the Act, and stated that,

" . . . it did not transport natural gas in interstate commerce or sell natural gas in interstate commerce for resale for ultimate public consumption for domestic, commercial, industrial, or any other use."

The Court of Appeals held these denials were in the nature of legal conclusions and were not denials of the statements of fact set out in the exhibit. Consequently, the company was deemed to have admitted the facts alleged in the exhibit under Rule 8(b). So that, Your Honor, when we set forth an

exhibit annexed to either a complaint, answer or motion, all statements in that exhibit are in the pleadings for all purposes by virtue of our new Federal rules. I say "new." They have been in effect, what is it, seven, eight, nine years now? And in consequence they call for a responsive pleading. If there is no responsive pleading, then under the provisions of 8(d), "Effect of Failure to Deny," it requires a responsive answer, being facts stated in a part of the pleading, and they are admitted for failure to deny.

So that, Your Honor, to save my point, I renew my objection to these letters going in on the ground that the [356] claim for refund sets forth facts in answer to the Commissioner's position which facts haven't been denied. I will admit, Your Honor, that solely and simply for the purpose of determining what items of income were passed on by the Commissioner, solely for the tabulation; if the offer were confined to that it would be proper. But as I understand it, the offer made is for all purposes. I have no objection to it going in just merely to show the tabulations, Your Honor.

Mr. Atherton: The offer is made for all purposes. It is made to lay the foundation that the taxpayer had not overcome the prima facie determination of the Commissioner. If the taxpayer is honest in his present position, Your Honor, it seems to me that he is rather untimely now. He should have moved for a judgment on the pleading at some other earlier stage of this proceeding. He has of-

ferred evidence here. He has practically admitted that there was a general denial on the part of the Government to his complaint. Otherwise he has taken up this Court's time, my time, and everybody else's time unnecessarily. Now he is seeking relief on a hypothetical issue.

The Court: Well, you said something about when this matter first came up that it was your intention, as I gathered it, to amend your answer to conform with the evidence.

Mr. Atherton: Yes, Your Honor, that is what I intended to do, at the close of the Government's proof in this case to [357] move then that the pleadings be amended to conform to the proof in the evidence.

Mr. Wild: Might I suggest, Your Honor, if counsel can do that now, what good are those rules? We might just as well tear up 8(c) and 10(d). They are of no effect. I had to go forward on certain evidence, on certain matters that are denied. Therefore, I didn't file a motion for judgment on the pleadings. I certainly don't enjoy any counsel, especially a strange counsel, impugning my honesty of motive, why I wasn't honest with the Court. I certainly was honest with the Court. I put on the evidence what I think answers completely everything that was denied. And I think on the basis of that we should claim judgment.

Mr. Atherton: Your Honor, it is within your discretion to determine whether or not these allegations in the complaint, to which he says there has

been admission, required a responsive pleading, in the sense that he believes such a responsive pleading should be made.

The Court: Well, I wouldn't think so. That case cited is a little distressing, if I got all of it, however. It would seem to me that the failure to deny is simply an admission that such a document exists and was placed before the Court in the Plaintiff's pleading.

Mr. Wild: Well, then, what does Your Honor do with 10(c)? Do you brush that aside and say it is meaningless, [358] when you annex an exhibit to a complaint, not technically, Your Honor? When I followed these rules down—and this isn't the first case that I ever pleaded under the rules—I came to the conclusion that whatever exhibit I had was an allegation, and it certainly was under 10(c). And all authorities that I looked at, being scarce then, the general authority and the notes, led me to believe that that is true.

The Court: I wouldn't have thought that that rule meant that.

Mr. Wild: Well, what does it mean?

The Court: Look what a field for slipshod, dangerous, treacherous pleadings it would open up.

Mr. Wild: Well, doesn't it all? There is the exhibit, and we all know that it is an averment of fact. And anybody, and especially Government counsel, should know their rules of pleading. And there isn't any ground for being slipshod there, Your Honor, I wouldn't think. I knew at the time

I prepared my complaint that when I annexed a written instrument as an exhibit that it was in for all purposes. And I plead it that way on purpose under that rule, Your Honor. And I don't see where there is any trick or any slipshodness about it. The whole thing is, Your Honor, that it calls upon the Defendant or the Plaintiff, as the case may be, if the instrument is in the Defendant's answer it calls upon them to deny the truth of any allegation of fact that is made in [359] that exhibit. And if they don't care to do that, that is all right.

Now, I had to put on some other evidence, naturally, because there are one or two things here that we denied. And I put on the other evidence now. And then I claim that this 90-day letter can't be adduced in evidence to overcome or show anything.

The Court: Well, upon the Defendant's assertion that it is the intention to move to amend the Defendant's pleading in answer, the objection is overruled.

Mr. Wild: May we have an exception, Your Honor? May we have one ground there that wasn't stated, because Your Honor ruled that it was upon his assertion that he was going to move to amend that that it was allowed? On the further ground I want to make my objection and exception, that any such procedure destroys the efficacy of our rules of pleading, because it permits a party to avoid, and if there is to be any avoidance it should have come at an early date instead of waiting eight years after. In other words, their motion to amend is far too late, Your Honor.



The Court: Well, as I understand it, a motion to amend can be made any time before judgment.

Mr. Wild: But it could only be made to conform to the proof. You can't pull yourself up by your bootstraps. You can't put in your proof first and then say, Your Honor, I [360] want to amend it, I want to amend it to conform to the proof. The proof has to go in first. Now, his motion to amend has got to be based upon the proof being in the record. And here the only way he'd get that evidence in the record upon which he bases his motion to amend is by putting it in after the motion to amend could be granted, you see, and as it isn't in evidence at that time there is no ground laid for amending the pleading.

And these rules of court, Your Honor, they are not traps to trap the unwary. Government counsel have volumes—I had reference to them—of how they should plead these things. I have one myself. Your Honor has one. I submit, Your Honor, that Government counsel when he went over there at that time, when they went off there they couldn't deny allegations of fact in that and that they therefore refused to put in a denial. I don't know what motivated them. I am quite certain that nobody got caught off third base by not knowing that an exhibit required a responsive pleading, because all you had to do is pull the book down and read it. And it says in there that it is in for all purposes. The mere fact that this counsel comes out here eight years late to try this case, while we were

dickering before on settlement, gets a different theory on the case than the Government and counsel who filed the answer, doesn't afford any basis for a change, Your Honor. [361]

Mr. Atherton: Your Honor, I have no different theory than the man who filed the answer.

The Court: All right. Unless you want to clear up something, we will go ahead.

Mr. Atherton: Mr. Wild, you asked that these exhibits be numbered in your case?

Mr. Wild: Well, I would assume it would be Defendant's Exhibit A.

Mr. Atherton: Defendant's Exhibit A.

Mr. Wild: And may we have our exception to the ruling?

The Court: Yes.

The Clerk: Defendant's Exhibit A.

(The document referred to was received in evidence as Defendant's Exhibit A.)

Mr. Atherton: Defendant also offers in evidence a photostatic copy of a true copy of a Commissioner's second deficiency 90-day letter dated June 29, 1938, addressed to American Factors, Limited, wherein he made a determination of a deficiency of \$12,657.68 in income tax for the taxable year ended December 31, 1932.

Mr. Wild: May we have the same objection, Your Honor?

The Court: Yes.

Mr. Wild: And the same exception?

Mr. Atherton: That may be marked as Defendant's Exhibit B. [362]

(The document referred to was received in evidence as Defendant's Exhibit B.)

Mr. Wild: I understand, counsel, that those are photostatic copies.

Mr. Atherton: True photostatic copies of the original letter. I have the original carbons in my file, if there is any question about it. May I inquire, is the corporation's 1932 income tax return in evidence?

Mr. Wild: I believe I called on counsel to provide it. I believe it is our P-1. No, it isn't either. No, it is P-6. Our photostatic copy of our income tax return for the calendar year 1932 is Exhibit P-6, Your Honor.

Mr. Atherton: I don't believe, Your Honor, that the Government has any other documentary evidence or otherwise to offer in this case.

Mr. Wild: Do you have the letter rejecting——

Mr. Atherton: I will offer the claims, if you want that. I will offer the claims for refund, if I may be permitted, then. I will offer in evidence as Defendant's Exhibit——

The Court: That would be C if it is accepted.

Mr. Atherton: I am just trying to identify them. Defendant's Exhibit C, a certified photostatic copy of the claim for refund filed by American Factors, Limited, with the Collector of Internal Revenue at Honolulu on April 5, 1938, for the claiming of refund of \$80,254.41. [363]

The Court: \$80,254.41?

Mr. Atherton: Federal income tax and interest for the calendar year ended December 31, 1932.

Mr. Wild: That is a true copy of it.

The Court: December 31st?

Mr. Atherton: 1932.

The Court: Oh, yes.

Mr. Atherton: That is a claim for refund.

The Court: Of \$80,254.41 tax from this date that it was presumably paid?

Mr. Atherton: Yes, it is a claim for refund of the tax they paid for the year 1932.

The Court: With the interest to run from when?

Mr. Atherton: Interest? Well, it doesn't say when the interest is to run. It merely states that the date of payment was December 30, 1937, so I assume that the interest to run from that date, your Honor. Let me see if I have——

Mr. Wild: Yes, the interest would run from the date of payment, your Honor.

The Court: Yes.

Mr. Wild: And the date of payment is shown here as December 30, 1937. Do you offer that in evidence for all purposes?

Mr. Atherton: For all purposes.

Mr. Wild: We have no objection. [364]

The Court: Received as Exhibit C.

Mr. Atherton: I am not offering this as evidence of the truth of the statement, the allegations made therein. I am offering it in evidence as a true copy

of refund filed. That is the limited purpose of the offer.

(The document referred to was received in evidence as Defendant's Exhibit C.)

Mr. Atherton: Now I wish to offer as Defendant's Exhibit D a true photostatic copy of a letter dated December 2, 1938, addressed to American Factors, Limited, by the Deputy Commissioner of Internal Revenue, notifying the taxpayer of the rejection of its claim for refund of \$80,254.41.

Mr. Wild: What is the date again?

Mr. Atherton: Income tax for the year 1932.

The Court: Rejection of how much?

Mr. Atherton: \$80,254.41.

The Court: That is the entire claim?

Mr. Atherton: That is the entire claim.

Mr. Wild: Is that December 2nd?

Mr. Atherton: Yes.

Mr. Wild: No objection.

The Court: Received as Exhibit D.

(The document referred to was received in evidence as Defendant's Exhibit D.)

Mr. Atherton: And I'd like to offer in evidence as [365] Defendant's Exhibit F——

The Court: Why miss E?

Mr. Atherton: This is E now?

The Court: Yes.

Mr. Atherton: Sorry. Defendant's Exhibit E, a true certified copy, photostatic copy of a second claim for refund filed by American Factors, Limited,



with the Collector of Internal Revenue at Honolulu on December 23, 1938, claiming the refund of \$16,880.49, of which \$12,657.68——

The Court: Twelve thousand what?

Mr. Atherton: ——\$12,657.68 represented income tax for the calendar year ended December 31, 1932, and interest in the amount of \$4,222.81.

The Court: Four thousand two hundred?

Mr. Atherton: \$4,222.81.

The Court: How much claim on the whole business?

Mr. Atherton: That represents, the sum of those two amounts is the amount claimed to be refunded in this second claim for refund.

The Court: Well, what? What they claim is an additional or second claim, is it? Is it an additional or second claim, when you say \$12,657.68 for 1932 taxes?

Mr. Wild: Same year, your Honor. The Commissioner changed his mind.

The Court: What is the \$16,880.49? Is that also——[366]

Mr. Wild: Yes, your Honor.

The Court: Is that also in 1932?

Mr. Wild: Yes, your Honor. In the Commissioner's letter he allowed a portion of the Hackfeld litigation expenses.

The Court: I came across that somewhere.

Mr. Wild: And he allowed that as a deduction. He allowed the payment made to the widows and orphans of deceased employees, and then he as-

sessed a tax on the basis of reversing his position, and he assessed an additional tax on that account.

The Court: Well, where is the documentary exhibit that shows what he had allowed in the first instance?

Mr. Atherton: That is in the first 90-day letter, your Honor, that was put in here.

The Court: Oh, yes.

Mr. Atherton: And in the second 90-day letter is where he made the subsequent adjustment.

The Court: Now, you've got stuff in there that I haven't seen. All I know is just that there was a letter referred to as a deficiency, 90-day deficiency letter. That doesn't mean anything to me.

Mr. Wild: Well, your Honor, in the pleadings here I have it all set out, and they have admitted it by failure to answer. In my paragraph 20, for instance, that in and by said letter the said Commissioner disallowed its deduction, all but \$87,992.50, of the Hackfeld litigation expenses; and [367] stated that of the amount paid by Plaintiff on account of the Hackfeld litigation expenses only the amount of \$87,992.50 accrued during the year 1932. That is, in other words, in the first deficiency letter he did claim to disallow all of the Hackfeld litigation expenses except those items that were paid and settled in the year 1932, as are shown on Exhibit P-7; and the summary which shows recap total expenses, 1932, \$87,992.50. Now, he allowed that in the first letter.

The Court: He allowed a deduction of 87—

Mr. Wild: That's right, in the first letter.

The Court: In the first letter? That is in this Exhibit A?

Mr. Wild: That's right.

Mr. Atherton: That's right. In the first 90-day letter.

Mr. Wild: And I show that in my pleading.

The Court: Is it a long letter? Could we know what that exhibit means?

Mr. Wild: Well, in technical income tax problems, your Honor, as you know, the Commissioner of Internal Revenue in Washington, when he finally reviews a case, gets out a final letter and it is called a 90-day letter. That 90-day letter permits the taxpayer to file an appeal to the Board of Tax Appeals within 90 days after the date, after the mailing date of the letter, or it permits him to pay the tax when it is assessed and file suit for refund. In that 90-day letter [368] the Commissioner states the summary of his findings.

The Court: That's what I want to know.

Mr. Wild: And that is the letter that I objected to because our claim for refund answers it, and it's been admitted. And I take it that my exceptions to the reading and consideration of the letter and all those matters pertaining to it are noted?

The Court: Naturally.

Mr. Atherton: Do you wish me to read it?

The Court: Yes.

Mr. Wild: But I have pled the result of it in the complaint.

Mr. Atherton: Well, all this comes as a great surprise to me. Therefore, I had to extemporaneously prepare myself. I wish to reserve the right for the Government in a supplemental brief to discuss this aspect of the situation and some others.

Well, now, looking at this Defendant's Exhibit A, on the statement attached to that 90-day letter, deficiency letter, your Honor, it shows this, it says, first, it sets forth the tax liability to be \$62,438.82. And it states that no amount of that tax has been assessed and therefore it concludes that that same amount represents the deficiency. Continuing with the letter, the statement in the deficiency letter reads as follows: [369]

"The deficiency shown herein is based upon the report prepared by Revenue Agent H. A. Peterson, a copy of which has been furnished you, and other data available to this office. The adjustments producing the deficiency are shown in schedules 1 and 2, and exhibit 'A', attached.

"Careful consideration has been accorded the statements set forth in your protests dated March 29, 1935 and May 28, 1937, and depreciation schedules filed with the internal revenue agent in charge, Honolulu, Territory of Hawaii, on December 5, 1936, and proper allowance made therefor in the determination of the deficiency shown above.

"The exceptions to the proposed adjustments to income reported on your return for 1932, as set forth in your protest dated May 28, 1937, are summarized as follows:

“1. Miscellaneous unallowable deductions \$5,-694.00.”

The Court: Is that under contest?

Mr. Wild: No.

Mr. Atherton: Not under dispute at all. No contest about that.

“2. Litigation expense \$480,615.26.”

That item is in dispute in this proceeding.

“3. Waterhouse Trust Co., Ltd. adjustment \$50,000.00.”

That item is in dispute in this proceeding.

“4. Depreciation \$889.84.”

Mr. Wild: No dispute on that. [370]

Mr. Atherton: No dispute on that item. Then the statement continues to state the basis of the Commissioner's determination with respect to the items that are in dispute in the present proceeding. I take it your Honor doesn't wish me to read that.

The Court: No, I think you have read——

Mr. Atherton: Now, if we come to the other deficiency letter, your Honor, it will sort of make the record clear. Referring to Defendant's Exhibit B, your Honor, which is the second deficiency notice, dated June 29, 1938, in which the Commissioner determined an additional deficiency of \$12,657.68 against American Factors with respect to the taxable year ended December 31, 1932, as the statement which is on the second page of that letter shows that the adjusted tax liability as determined by the



Commissioner for the taxable year 1932 was \$75,-096.50.

The Court: Where is that?

Mr. Atherton: That is right in the beginning there, your Honor, right at the beginning, income tax liability.

The Court: Oh, there, yes.

Mr. Atherton: The next column shows assessed \$62,438.82. And the difference between those two amounts carried over to the last column shows the deficiency of \$12,657.68. The statement continues to read as follows:

“The deficiency shown herein is based upon the reports [371] prepared by Revenue Agent H. A. Peterson and L. J. Houghton, copies of which have been furnished you, and other data available to this office.”

The Court: Now let's get to the figures.

Mr. Atherton: Now, on page 2 we show that the return as reported showed a loss of \$80,546.59, instead of a taxable income. Then it shows the adjustments made by the Commissioner which resulted in an adjusted net income of \$546,156.37 instead of net loss. He adjusted it by adding back, that is, eliminating deductions, donations, totaling \$2,225. That is item 1. Item 2, donations, Hawaii Bureau of Governmental Research, \$1,000.

The Court: He struck that out?

Mr. Atherton: He struck that out. Three, litigation costs, \$568,607.76, which is in dispute in this controversy, as well as the preceding item. You see,

in other words, in this letter, your Honor, he not only disallowed what he previously disallowed before, the 480 of the litigation expense, but the additional \$87,000, I believe that was.

Mr. Wild: That's right.

The Court: That would make up——

Mr. Atherton: \$568,607.76. The next item——

The Court: In passing, the American Factors made no claim for the striking out of their Governmental Research?

Mr. Wild: No, your Honor. Unfortunately, we didn't [372] because the law I considered at that time was fairly well-settled. Since that time there have been new authorities and the Government's position has changed. It was a trifling amount and we didn't pay any attention to it.

The Court: Yes.

Mr. Atherton: The next item, then, was the Henry Waterhouse Trust Company adjustment of \$50,000, which is in controversy. And the next three items, the next four items, five, six, seven and eight are not in controversy here.

The Court: Whereas the item classed as number 1, donations——

Mr. Atherton: That is not in controversy.

The Court: Well, it is now?

Mr. Wild: No, that isn't. You mean pensions?

The Court: Pensions.

Mr. Wild: Pensions is in controversy.

The Court: I think the department must have classified the pensions as donations.

Mr. Atherton: Miscellaneous unallowable deductions, that is \$4,063.33. That must be the pension item.

Mr. Wild: That's right.

Mr. Atherton: Yes, that is explained on page 10 of the deficiency notice, your Honor, explanatory item 8.

The Court: I heard nothing about that in that first one.

Mr. Atherton: No, the Commissioner, after he had a [373] second report on this taxpayer's return, after the claim, refund, was filed——

Mr. Wild: What happened there, your Honor, was simply this: I was back before the department and we argued this. The statute of limitations was about to run; the case was extensively settled right there and then; and they asked me to file a claim, waiver of the statute of limitations, and I said I wouldn't recommend my client doing it, that I didn't see any reason why we should. And so they threw the book at me, your Honor, because I wouldn't recommend the client waiving the statute of limitations. They still had several months to go to make up their minds in which to consider it. So they just knocked out everything else that there was in there and sent another letter. That is actually what happened.

Mr. Atherton: Now, your Honor, the letter shows by way of explanation of the Commissioner's adjustments, why he made them. I assume you don't wish me to read any more from that exhibit.

The Court: Maybe you should have stayed away, Mr. Wild.

Mr. Wild: Probably I should have.

The Court: We will take a recess now.

(A recess was taken at 3:13 p.m.)

After Recess

Mr. Atherton: Continuing, your Honor, I'd like to offer in evidence this true photostatic copy of the claim, second [374] claim for refund. I think I previously described it.

Mr. Wild: May I ask a question about the date on that? Isn't that the 22nd?

The Court: Twenty-third, I have it.

Mr. Wild: Well, I have a stamped copy. Our stamped copy is dated the 22nd. But I take it it is the same.

The Court: The date given me was the 23rd, '38.

Mr. Atherton: Well, it doesn't make any difference.

Mr. Wild: It doesn't make any difference. It is that claim, your Honor. And I've got one that was stamped in the revenue office up here, and that is just a photostat.

The Court: That is admitted in evidence as Exhibit E.

(The document referred to was received in evidence as Defendant's Exhibit E.)

Mr. Atherton: And I would like to offer in evi-

dence as Defendant's Exhibit F a true photostatic copy of a letter dated April 22, 1940, addressed by the deputy commissioner of Internal Revenue to American Factors, Limited, notifying the taxpayer that his claim for refund, that is, his second claim for refund of \$16,880.49 referred to here as Defendant's Exhibit E, with respect to the taxable year 1932, has been rejected in its entirety.

Mr. Wild: Yes, it is on account—you read it I think.

Mr. Atherton: Yes.

Mr. Wild: Yes, it said the reason is that a suit is pending [375] in the court. You see, your Honor, the law is, if a claim for refund is filed, as this was, the Commissioner has six months within which he may act on it. If he neither rejects it or accepts it within six months, the taxpayer is then privileged to sue. And I alleged in my complaint that more than six months had elapsed since the claim for refund had been filed, and no action taken by the Commissioners. So I filed a suit. After the suit was filed the rejection letter which is now offered as what—D?—F?

The Court: F.

Mr. Wild: —was sent saying that the claim for refund was denied because suit was pending.

Mr. Atherton: Your Honor, I'd like the record to show that these claims for refund are merely offered for the purpose of showing that the taxpayer filed them and that there is no variance between the allegations contained in the complaint and those



made in the claim for refund, but that there is no admission on the part of the Government that the allegations of fact contained in the claim for refund are true.

(The document referred to was received in evidence as Defendant's Exhibit F.)

Mr. Atherton: I think that concludes the Government's evidence with respect to the American Factors case.

Mr. Wild: Might I ask the Government to stipulate one [376] thing? The H. A. Peterson referred to in the letter was the H. A. Peterson that was here in court?

Mr. Atherton: Yes, I am willing to do that. I don't know why it is pertinent.

Mr. Wild: Well, I don't know that it is. What is your Honor's pleasure about argument to the Court? I have been trying to talk with counsel on all sides to see whether or not we could argue it all out in two hours, two and a quarter hours. That is the time for both sides and in both cases.

Mr. Atherton: There is one thing——

Mr. Wild: Excuse me. I thought you finished the case.

Mr. Atherton: There is one thing I wanted to do. I want to make the motion that I intended to make.

Mr. Wild: I thought you concluded the evidence.

Mr. Atherton: I move, your Honor, that the Government's answer to the complaint herein be deemed to be amended to conform with the evidence and proof adduced at this trial, and that goes with

respect to the American Factors case and the complaint in that case as well as the complaint filed in the Alexander and Baldwin case; and that if there is any question, the Government wishes the record to show that it denies all the allegations of fact contained in the claims for refund referred to in paragraphs 23 and 26, I believe, of the complaint in the American Factors case.

Mr. Wild: I just want to object, your Honor, on the [377] ground——

The Court: Just a moment. You consider an oral motion to amend the answer to be sufficient as a presentation of the thing to the Court?

Mr. Atherton: Well, if your Honor wishes me to do so, I will be glad to prepare a written motion.

The Court: Well, I haven't any preference about the thing but I am asking you if you think that is sufficient?

Mr. Atherton: I don't know that there is any reason to the contrary, but in order to be on the side of safety I ask leave, therefore, your Honor, to file a motion, a written motion to amend the answer.

Mr. Wild: We object, your Honor, to the allowance of the motion. And I don't want to go over all the grounds. May all my grounds as before stated be considered?

The Court: I think I understand your grounds, the nature and exceptions. The motion for leave to amend to conform with the evidence is granted. And you will bring your motion in?

Mr. Wild: May we have an exception, your Honor?

The Court: Yes.

Mr. Wild: And may we have an examination of the proposed amended answer because, your Honor, there isn't any evidence in the case that denies certain allegations that are made in our claims for refund? And in consequence, your Honor, [378] his motion, he now having rested, made this motion, I want an additional chance, then, to object and point out to the Court wherein there is a deficiency in it.

The Court: All right.

Mr. Wild: I don't want to take too much of the Court's time.

The Court: It wouldn't take you too long to analyze his motion?

Mr. Wild: No, your Honor, no.

The Court: And to present your objections?

Mr. Wild: I will do that almost immediately. I don't want to waste any time.

The Court: It is 20 minutes to four now. I haven't got much time. There are other things to be considered between now and Tuesday morning when I will have a jury on my hands with a continual run of jury work day after day. I relied on your estimate that you'd get through by noon with the presentation of the case and get in some argument this afternoon. Now you, Mr. Wild, want about an hour or over——

Mr. Wild: No. I have agreed with counsel that

if he will limit himself to three-quarters of an hour I will limit myself to three-quarters of an hour opening and closing on the Hackfeld litigation case. I felt that that would save the time of the Court, and I think we can cover our subject [379] in that time because our positions are well-known to your Honor now. And your Honor has certainly read these figures here and has them in mind. And I think Mr. Pratt says that he wants a very short time with his argument.

Mr. Pratt: I think perhaps ours won't take more than about 15 minutes, your Honor. We thought also that perhaps it would be wise to submit a written memorandum to the Court.

The Court: Well, I've got a memorandum here from the Plaintiff that was quite useful to me in understanding this; after I read the pleadings, and that with the quite full and comprehensive discussion that was going on here as the evidence was put in, much of which was argumentative and other discussion was instructive to me as to what the case is all about and what the points involved are, that I don't know that I would ask to burden you with any memorandum. Unless there is something that you think that you could emphasize to the Court.

Mr. Pratt: Just a matter of presenting the authorities, your Honor. It wouldn't be an extended memorandum, not in the nature of a long brief but merely discussing certain authorities.

The Court: Unless you discuss authorities, I don't believe it would be much use to me because if

I have to look them up myself, I'd simply have to lay the whole thing on the table for some indefinite time, possibly not before some [380] time next year. I don't want to do it.

Mr. Pratt: Well, if that is so, your Honor, it may take us a little over 15 minutes to cover the whole matter.

The Court: I don't want to limit you in your argument.

Mr. Wild: I expected that the Government would file one at the same time when we did. But I thought I had laid out pretty well the legal bases. I didn't discuss the cases much but I laid out the legal bases for guidance, as we went along. And do I get the idea now that your Honor feels that I should supplement that at all by further statement of the cases in writing?

The Court: I'd just as soon you do it in argument.

Mr. Wild: Very well, your Honor.

The Court: Have you got anything in writing, Mr. Atherton?

Mr. Atherton: Yes, I have a memorandum, your Honor, in writing.

The Court: All right, now.

Mr. Atherton: It is all ready. It doesn't cover the point of restitution,—I was going to say retribution—restitution, that my worthy opponent has introduced in his memorandum, a restatement of the law. I haven't got the restatement here and I would like an opportunity to supplement this memorandum by another one after I get back to Washington.



Mr. Wild: May we have a copy of that? [381]

Mr. Atherton: Because this isn't complete on every angle. It misses that. But it is complete in every other respect.

The Court: Can't you give me your other angles in your argument?

Mr. Atherton: Well, I can do my best orally about it, but it is not going to be altogether satisfactory to me and probably not too satisfactory to my office. I have to think of what the policy is in the office. That is unfortunate.

The Court: I know, but you have to take into consideration that this is a trial court, though, and a rather busy one. We don't have the time that the appellate court has, to go into our chambers and send our clerks for books all marked and ready to read. We don't have any law clerk to help us and to come in and dump half a hundred authorities in the judge's lap and say, here's your authority for this, that and something else. It just can't be done. We can't keep up with it.

Mr. Atherton: Well, I will file this memorandum with your Honor. It has been revised.

The Court: Well, I will read that overnight. I took home a 138-page brief last night and got myself to sleep with it.

Mr. Wild: Well, I would like to be furnished with a conformed copy. I gave counsel a statement of our position [382] at the outset. He has had the benefit of that as we had gone along, and I'd like to see what his position is as stated there, at least a little while before we have the argument.

Mr. Atherton: Well, I haven't got it prepared. You know there is quite a shortage of stenographic help in the United States Attorney's office. One of those young ladies worked here a couple of nights with me in trying to get these pages rewritten, and the carbons haven't been conformed to the copy that I am handing, all except one, and I have the one in my possession.

Mr. Wild: I think we are entitled to that one.

The Court: When can we get to argument?

Mr. Wild: Well, what is your Honor's pleasure?

The Court: My pleasure would be to go ahead tomorrow morning, but I can see that you are not all prepared.

Mr. Wild: I am prepared, your Honor, but I do think that I am entitled to see the Government's position before we argue. If your Honor would rather have it over the week-end, I will go right ahead tomorrow morning, if your Honor wishes, but I would like to get it tonight before that argument, his position so that I can analyze his cases. I think I know some of the cases he is going to cite and I think, your Honor, I can distinguish them offhand but I am not sure.

The Court: Well, suppose, then, Mr. Atherton, you let Mr. Wild have your memorandum that you have prepared, with [383] the understanding that he get it to me by tomorrow evening so that I can work on it, read it and consider it.

Mr. Wild: You mean the one that was filed with your Honor?

The Court: This one that hasn't been filed.

Mr. Wild: Oh, yes.

The Court: There has been nothing filed.

Mr. Wild: I thought he presented it. Yes, he has one.

Mr. Atherton: I was going to do this. I think it would be better, so we can go on with argument tomorrow morning.

The Court: No—well, go ahead.

Mr. Atherton: I will hand you my only copy and I will rely on my previous memorandum and let the Judge have the original, the original of the revised copy, and then that will put you in a position where you will know what I am going to talk about.

Mr. Wild: Well, the Judge said he'd prefer not to argue tomorrow.

Mr. Atherton: I will get the revised copy to him.

Mr. Wild: Well, if the Judge isn't going to argue tomorrow, then if I can borrow the other, you can make the other revisions and hand that to the Judge by tomorrow noon or tomorrow night.

Mr. Atherton: I was trying to get the case for argument tomorrow so that we can get it over with. That's what I was [384] trying to do. I want to do everything I can to help your Honor to get the case on tomorrow so we can finish it up.

The Court: Well, I am slightly apprehensive this way, that I don't want either side to feel that they are being hurried and denied every opportunity that they should have to be fully prepared for argument,

because I have got to fashion what I can, and when I have heard all of the case and heard the argument I generally have my mind made up, make it up then, because I can't carry too many of these things for weeks. And it may result in carrying them for months. And that means it will simply go through a record that requires a week or two and then doing it all over again. With the backlog that the reporter has, it will take him a month before he can give me a transcript.

Mr. Wild: Well, when did your Honor want to have it argued, tomorrow morning or when, your Honor?

The Court: Would you all be ready tomorrow morning?

Mr. Wild: I hope to be.

Mr. Pratt: We can be ready, your Honor.

The Court: Well, tomorrow is my day off and I've got another appointment.

Mr. Wild: If your Honor would rather prefer it Monday——

The Court: Well, I've got so many things to think about Monday. Let's make it tomorrow. What time do you want to start? [385]

Mr. Wild: What time would your Honor care— 10 o'clock?

The Court: What time do you want?

Mr. Atherton: Ten o'clock is agreeable to me.

The Court: That would run it until about one o'clock?

Mr. Wild: Well, as I understood it, we confine

ourselves to an hour a piece. I have no more than an hour on opening and closing. And the Government will have no more than an hour in their argument. Then there would be 15 minutes and 15 minutes. That would be half an hour. So that would be two hours and one-half. That would be about 12:30.

The Court: Do you want to commence half past nine?

Mr. Wild: Well, you see, counsel has had the benefit of seeing my cases for a week now. I haven't even seen his. And I would like a minute, your Honor, just to take a look. I think I know the cases he has cited and I think I can distinguish the ones that should be distinguished, but I am not positive until I see them, your Honor. And if I can see it tonight, why——

Mr. Atherton: I will show it to him tonight.

The Court: All right. Ten o'clock tomorrow.

(The Court adjourned at 3:55 p.m.) [386]

November 15, 1947

(Court convened at 10:00 a.m.)

The Clerk: Civil No. 419, American Factors, Limited, versus Fred H. Kanne; case called for argument.

Mr. Wild: Ready for the Plaintiff.

Mr. Atherton: Ready for the Defendant, your Honor. The Defendant has a written motion to amend its answer to conform to the evidence, together with a memorandum of points of authorities



which we would like to file now with the Court, your Honor.

The Court: Has opposing counsel seen it?

Mr. Wild: No, your Honor. I am just getting a copy.

Mr. Atherton: Shall I read the motion, your Honor?

The Court: Yes.

(Mr. Atherton read the documents referred to.)

(Mr. Atherton presented argument on the motion to amend Government's answer.)

The Court: Well, as near as I can tell, everything that was brought in issue has been either admitted or denied. I believe that the Defendant is entitled to amend his answer, which of course would be an amendment *Nunc pro tunc*. I can see nothing injurious to the Plaintiff in the amendment, in view of what has gone on here this morning. The motion to amend is granted. [387]

Mr. Wild: May we have an exception, your Honor?

The Court: Let an exception be noted in the record.

(Mr. Wild presented the argument on behalf of the Plaintiff.)

(Mr. Pratt presented the argument on behalf of Alexander and Baldwin, Limited.)

Mr. Wild: Your Honor, might I ask that that argument may be considered also as part of our argument?

The Court: Yes.

(The Court recessed at 12:15 p.m.)

### After Recess

(Mr. Atherton presented the argument on behalf of the Defendant.)

(Mr. Pratt presented the closing argument on behalf of Alexander and Baldwin, Limited.)

(Mr. Wild presented the closing argument on behalf of the Plaintiff.)

(Mr. Atherton presented his reply argument on behalf of the Defendant.)

The Court: As to the American Factors, Limited——

1. Hackfeld Litigation: My opinion is that the persons who subscribed to pay voluntarily for the defense of this inordinately costly litigation were impulsed and motivated entirely by keen personal desires to defeat the demands of [388] the plaintiffs in the case and clear themselves as defendants against claims that they had unlawfully conspired and acted in fraud and greed, as well as to escape a liability in damages by a possible judgment against them and to protect their individual investments as shareholders in the corporation, and that they were

willing and made a definite offer to pay, and did pay to the extent of assessments made against them, without promise or original expectation of reimbursement at the time and times they made their contributions to the litigation fund.

There is no evidence that the taxpayer promised or implied an intention to reimburse them at the time they subscribed or made their contributions, and no evidence that the taxpayer even considered the matter until the backbone of the litigation was broken in victory to all the defendants.

There was no demand by them or test of their right to have contribution at the expense of other shareholders who were not named as parties defendant. The approval at a stockholders' meeting and the act of the management in reimbursing these contributors from the company's funds apparently flowed largely from feelings of gratitude arising from the successful outcome of the case in litigation and the liberal aid of the contributors and their steering committee which contributed many facilities and influences such as could not have been supplied by the management of American [389] Factors acting alone.

Certainly, the taxpayer had very substantial interests to protect, and was justified in every way as a legitimate business outlay, in paying from its own funds during the taxable year of 1932, or earlier years had it chosen to do so, the costs of litigation which imperiled its existence, although others were involved in the same litigation as defendants and

had much to lose, had the others not come forward with funds and volunteered to engineer and fight the battle at their own costs and had the taxpayer not accepted this offered payment-plan and the volunteered services; either of the parties could have abandoned or modified this plan at any time, but so long as it was adhered to it was binding on both; but the taxpayer was not justified, in the realm of taxation laws and deductibles, to later deduct from taxable income the money it paid to reimburse voluntary contributors for money which they had paid out to clear themselves of fraudulent charges made against them collectively and individually and to protect their property interests, no matter if victory in such defense brought great benefit to the taxpayers as well as to the other named defendants.

As between share owners, of course, within ultra vires limitations, they were empowered to make any desired distribution of the company's funds so long as none was injured.

The taxpayer is entitled to an expense-deduction in its [390] 1932 tax return of the sum of all Hackfeld Litigation paid by it prior to the end of 1932, less the amount paid in to it for that purpose by the other defendants.

2. As to the Waterhouse Trust Company contribution of \$50,000, this was just that—a contribution. The note given in acknowledgment of the contribution was contingent as to value upon such conditions as to give it no negotiable value from the time it was made. It could not be dealt with as a

debt. The considerations in payment for the contribution flowed to the payee at the time it was made—the protection of the commercial community, sympathy toward Waterhouse Company clients who could ill afford to lose, and other commendable desires and motives of helpfulness and security, but there was no attempt to show that either American Factors or Alexander and Baldwin would have suffered any loss had they not attempted to keep the Waterhouse Trust Company a going concern.

I find that no part of this contribution was deductible as a bad debt or loss in 1932 or at any other time since it never was a collectible debt, but was from the beginning in the nature of a contingent or speculative gift, to which status it speedily resolved itself with certainty, although it may have accomplished in part the purpose for which it was intended, that is, prolonged the life of Waterhouse Trust Company. [391]

3. As to the items of contributions or pensions to dependents of deceased employees, I am fully convinced from the evidence that this was a usual and, within ordinary business discretion, a necessary and proper business practice. It is well recognized that it would reasonably tend to the gratification, good will and loyalty of employees in general and thus be a benefit to business operations, particularly in a business under many department heads and of ramified operations.

I find these items to be proper income tax deductions.



Alexander and Baldwin, Limited:

1. My opinion and finding with respect to the Waterhouse Trust contribution in the American Factors case is, in all pertinent respects, applicable to the refund claim of this litigant and the said claim is denied.

2. As to the contribution to maintain the Hawaiian Bureau of Governmental Research, I find this to be an ordinary and necessary expense to a firm carrying on the business and business trusts and responsibilities such as Alexander and Baldwin carry.

If more extensive findings and conclusions are desired, the prevailing parties may prepare and submit such proposals to me, after tendering copies to opposing counsel.

Mr. Wild: Your Honor, on behalf of American Factors may we except to the ruling of the Court that the amount of [392] \$396,812.50 is not an allowable item of deduction, and for failure of the Court to rule that if it wasn't an allowable deduction for the particular year then that it was an additional amount attributable as a deferred payment to the cost of the assets and business of the company? May we also have an exception, Your Honor, to the denial——

The Court: Don't go too fast because this is the only record you've got.

Mr. Wild: An exception to the findings of the Court concerning the Henry Waterhouse Trust

Company note. And may it be understood that there are a good many other points of exception that I would like to make? One is that there is no evidence in this case that shows on the first issue that the persons who subscribed for and paid this fund did so without any expectation of reimbursement if the litigation was successful. On the additional ground that the Court has failed to recognize the rule of law under which restitution was required under the facts of the case, even though there was no agreement or understanding between American Factors and the other parties that this amount should be returned.

And on the further ground that the decision of the Court fails to take into consideration the fact that to permit American Factors to keep for itself the benefit of the payment of \$396,812.50 of the litigation expenses under these circumstances [393] amounts to an unjust enrichment of American Factors which under the circumstances of this case it was obligated in 1932 to make restitution of to the other 23 defendants.

I think that covers it all, Your Honor.

The Court: Well, you may add anything to it that you want, that you give further thought to.

Mr. Bortz: Your Honor, I'd like to note for the purpose of the record an exception to the findings incorporated in paragraph 1 in behalf of Alexander and Baldwin.

The Court: Under Alexander and Baldwin, yes.

Mr. Wild: With the permission of the Court I

would like to add to my former exceptions the old stock one, that the opinion of the Court concerning the \$396,812.50 item in the Hackfeld litigation expense item is contrary to the law, contrary to the evidence, is contrary to the weight of the evidence, and that there is no evidence in this record to support the statement that the persons subscribed voluntarily, were impulsed and motivated entirely by keen personal desires to defeat the demands of the plaintiffs in the case and clear themselves as defendants against claims that they had unlawfully conspired and acted in fraud and greed, as well as to escape a liability in damages by a possible judgment against them and to protect their individual investments as shareholders in the corporation.

The Court: Of course that is a conclusion drawn from [394] the evidence.

Mr. Wild: Well, I say that there is no evidence which supports the conclusion that these men were impulsed and motivated entirely by keen personal desires to defeat the demands of the plaintiff. It is our contention that on the record, as a matter of law, they were impulsed and motivated by the fact that they knew if the charges were accurate they were liable, and that they therefore depended on that. And I think there is no evidence to support that, Your Honor.

The Court: I gathered that largely from that agreement there entered into.

Mr. Wild: But the agreement, Your Honor, says nothing about that.

The Court: Well, I could be wrong there.

Mr. Wild: And further on the ground that there is evidence in the case that the taxpayer promised or implied an intention to reimburse them at the time they subscribed or made their contributions, arising from the facts and circumstances and the law applicable thereto, and stated in the theories of restitution under unjust enrichment; that the agreement arises not because of any promise made, oral or in writing, but by virtue of the circumstances and lays the foundation for a claim. And on the further ground—no, I think I have stated that. I think I have stated all my grounds. [395]

The Court: Well, you may take another turn at it.

Mr. Atherton: Your Honor, may I ask for a matter of information, this statement here on page 3, it says, "The taxpayer is entitled to an expense-deduction in its 1932 tax return of the sum of all Hackfeld Litigation paid by it prior to the end of 1932, less the amount paid in to it for that purpose by the other defendants." In other words, do I take it from that that you are allowing the taxpayer a deduction of \$171,000?

The Court: As to the figures, I am not certain. I couldn't carry them so well. But they paid out a gross sum, and they received from the other defendants; it was their contribution. Now, the difference between what they paid out and what they received from the other defendants by way of contribution, that if it was accrued prior to the taxable year 1932,

I hold they are entitled to recover by way of deduction.

Mr. Atherton: In 1932?

The Court: Yes. Does that express the sense——

Mr. Atherton: Yes, it explains it. That's the way I have visualized it. It is the difference between the 396 and the 568.

The Court: That's right. I haven't figured it out.

Mr. Atherton: I want to say here with respect to the remarks made by Mr. Wild after you handed down your written [396] opinion, I think that they should be expunged from the record. All that goes to the appeal, if he wants to take an appeal. The case is closed now.

The Court: I don't follow you there. Now he takes an exception to these brief findings and the opinion in spots, and he sets out in the record the basis for his objections. I think that is perfectly proper.

Mr. Wild: It has always been our practice, Your Honor.

Mr. Atherton: What I had in mind, supposing I had to return to Washington and you had written this opinion a month or two later.

The Court: I probably would hand you a better-finished article, but I want to get through with the case.

Mr. Atherton: I am much pleased with it myself, personally. But what I mean is, I have never yet in any cases I have appeared in for the Government



ever interposed at the conclusion of the case, after the judge had rendered his opinion from the bench—and it has happened down in Texas several times—any exception by the Government, although the decision had been against the Government. I never heard counsel for the other side ever do so. It strikes me as an extraordinary presentation, that if he wants to take an appeal he should notice his appeal.

Mr. Wild: We can't note an appeal from the decision, as you know. If rendered in open court, we state our objections [397] and take our exceptions. That's all. It has always been our practice.

The Court: It is my opinion that that is proper.

Mr. Atherton: Well, if that is so, then I, as a matter of record, I'd like the record to show that the Government takes exception to the last paragraph of your finding No. 1 with respect to the Hackfeld litigation expense insofar as it allows as a deduction to the American Factors corporation in the year 1932 for tax purposes the sum of \$83,812.50, I believe, which represented that part of the Hackfeld litigation expense incurred and paid prior to the taxable year 1932. And with respect to the balance, as well as that that the Government takes exception, to the allowance of any part of the litigation expense on the ground that it did not represent ordinary and necessary expense of doing business by American Factors.

Now, as to the item in paragraph 3, No. 3 of your findings, Your Honor, respecting the contributions

of pensions, the Government wishes to register its exception to that finding and the same with respect to the finding No. 2 under the Alexander and Baldwin, Limited, case concerning the contributions to the Hawaiian Bureau of Governmental Research.

And I want to thank you personally for your patience.

The Court: It is hardly appropriate for me to say that you are welcome, because that is what I am here for. [398]

Mr. Wild: I must say, Your Honor, you have been very patient in dealing with us. We have certainly taken up all your time on Saturday afternoon.

The Court: Now, Mr. Atherton, you, upon the whole and largest measure, seem to be representing the prevailing party. I am going to call on you to prepare appropriate findings and conclusions.

Mr. Atherton: I will try and get them out. I will start on them Monday.

The Court: When you do, submit a copy to your esteemed antagonist, both of them, and they may have something to say and they may want findings, they may want to submit findings of their own design.

Mr. Wild: Yes, Your Honor, we might.

The Court: And the Court will entertain all those in due course. Now, is there anything more before the Court at this time? Is there? The Court stands adjourned until Monday morning.

(The Court adjourned at 4:45 p.m.) [399]

CERTIFICATE

I, Albert Grain, Official Court Reporter, U. S. District Court, Honolulu, T. H., do hereby certify that the foregoing is a true and correct transcript of proceedings reported by me in Civil No. 419, American Factors, Ltd. versus Fred H. Kanne, and Civil No. 474, Alexander and Baldwin, Ltd. versus Fred H. Kanne; proceedings held in the above-named court on November 12, 13, 14, 15, 1947, before the Hon. Delbert E. Metzger, Judge.

Nov. 26, 1949.

/s/ ALBERT GRAIN.

[Endorsed]: Filed December 8, 1949.

[Endorsed]: No. 12391. United States Court of Appeals for the Ninth Circuit. Agnes M. Kanne, Executrix under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, Appellant, vs. American Factors, Limited, an Hawaiian corporation, Appellee-Appellant, and vs. American Factors, Limited, an Hawaiian corporation, Appellant, vs. Agnes M. Kanne, Executrix under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, Appellee. Transcript of Record. Appeals from the United States District Court for the District of Hawaii.

Filed November 2, 1949.

/s/ PAUL P. O'BRIEN,  
Clerk of the United States Court of Appeals for  
the Ninth Circuit.

United States Court of Appeals  
For the Ninth Circuit

No. 12391

AMERICAN FACTORS, LIMITED, an Hawaiian  
corporation,

Plaintiff,

vs.

AGNES M. KANNE, Executrix under the Will and  
of the Estate of Fred H. Kanne, Collector of  
Internal Revenue of the United States for the  
District of Hawaii,

Defendant.

STATEMENT OF POINTS TO BE  
RELIED UPON

Comes now, American Factors, Limited, the plaintiff in the above entitled cause, and states that the points upon which it intends to rely in its appeal are as follows:

The United States District Court for the Territory of Hawaii erred:

1. In concluding that plaintiff is entitled to a deduction of only \$171,795.26 instead of \$568,607.76 of the Hackfeld litigation expenses as ordinary and necessary expenses paid or incurred during the taxable year 1932;

2. In concluding that \$396,812.50 of the Hackfeld litigation expenses, which plaintiff refunded or



repaid in the year 1932 to persons and corporations who were codefendants with plaintiff in said litigation, were not ordinary or necessary expenses paid or incurred during the year 1932;

3. In failing to find and hold that the Commissioner of Internal Revenue erred in disallowing plaintiff a deduction of \$568,607.76 of the Hackfeld litigation expenses in computing its net taxable income for the year 1932;

4. In concluding that there was no legal obligation or liability on the part of the plaintiff to reimburse or refund to its stockholders who were codefendants with it in the Hackfeld litigation, the sum of \$396,812.50 which plaintiff repaid to them in 1932;

5. In failing to find and hold that even in the absence of any legal obligation or liability on the part of the plaintiff to reimburse or refund to its stockholders who were codefendants with it in the Hackfeld litigation, the refund or repayment to them was nevertheless an ordinary and necessary expense of the plaintiff paid or incurred during the year 1932;

6. In concluding that the payment of \$50,000.00 to the Henry Waterhouse Trust Company, Limited, in 1931, by plaintiff, was just a contribution;

7. In concluding that the note given by Henry Waterhouse Trust Company, Limited, in 1931, to the plaintiff, was contingent in payment; was subject to such conditions as to render it nonnegotiable,

and was without any negotiable value at the time it was made and at all times thereafter;

8. In concluding that the note given by Henry Waterhouse Trust Company, Limited, in 1931, to the plaintiff, could not be dealt with as a debt;

9. In concluding that the contingencies as to payment and/or the lack of negotiable value prevented said note from being evidence of a debt;

10. In concluding that the Commissioner of Internal Revenue did not err in disallowing plaintiff a deduction therefor as a bad debt in computing its taxable net income for the calendar year 1932;

11. In concluding that no part of the payment of \$50,000.00 made to Henry Waterhouse Trust Company, Limited, in 1931, by plaintiff, was deductible as a bad debt ascertained to be worthless and charged off within the tax year 1932, or as a loss sustained during that taxable year;

12. In failing to render judgment in favor of the plaintiff for the amount of \$97,134.90 instead of the amount of \$31,691.18 on account of plaintiff's overpayment of income tax for the year 1932.

Dated: Honolulu, T. H., November 1, 1949.

SMITH, WILD, BEEBE  
& CADES,

By /s/ MILTON CADES,

Attorneys for American  
Factors, Limited, Plaintiff.

[Endorsed]: Filed November 2, 1949.

[Title of Court of Appeals and Cause.]

DEFENDANT - APPELLANT'S STATEMENT  
OF POINTS ON APPEAL PURSUANT TO  
RULE 19

1. The court erred in concluding that Plaintiff-Appellant is entitled to a deduction of \$171,795.26, or any part thereof of the Hackfeld litigation expenses as ordinary and necessary expenses paid or incurred during the taxable year 1932.

2. The court erred in concluding that the Commissioner of Internal Revenue erred in disallowing the Plaintiff-Appellant a deduction for the amount of \$171,795.26, or any part thereof, of the Hackfeld litigation expenses in computing its taxable net income for the year 1932.

3. The court erred in failing to find and hold that all of the Hackfeld litigation expenses had been incurred and had accrued prior to the taxable year 1932.

4. The court erred in failing to find, in accordance with the stipulation of facts No. II, that all of the Hackfeld litigation expenses, except \$87,992.50, were actually paid prior to the year 1932.

5. The court erred in holding that the Plaintiff-Appellant was entitled to recover any income tax paid by it for the taxable year 1932 attributable to the denial of the deduction of the Hackfeld litigation expenses.

6. The court erred in rendering judgment in favor of the Plaintiff-Appellant in any amount in excess of the overpayment of income tax for the year 1932 attributable to the deduction for payments made to dependents of deceased employees.

Dated: Honolulu, T. H., this 31st day of October, 1949.

/s/ RAY J. O'BRIEN,

Attorney for the United States, District of Hawaii,  
Attorneys for Agnes M. Kanne, Executrix  
under the Will and of the Estate of Fred H.  
Kanne, Collector of Internal Revenue of the  
United States for the District of Hawaii, De-  
fendant-Appellant.

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[Title of Court of Appeals and Cause.]

STIPULATION AS TO DESIGNATION OF  
RECORD TO BE PRINTED

Pursuant to Rule 19 of this Court Plaintiff-Appellant and Defendant-Appellant hereby designate for printing the following portions of the record on appeal. (References in the left-hand column are to item numbers as set forth in the designation of the record on appeal.)

1. Complaint;
2. Defendant's original Answer;

3. Motion to Substitute Executrix as Defendant, with Consent of Executrix;

4. Defendant's Motion to Amend her original Answer to Conform with the Evidence, filed November 17, 1947;

5. Transcript of testimony of S. M. Lowrey, H. C. Eichelberger, W. T. Vorfeld, T. G. Singlehurst, E. J. Greaney, A. L. Castle, A. L. Dean, and C. R. Linden;

6. Exhibits P-5, P-6, P-7, P-8, P-9, P-10, P-11 and P-13;

7. Statement of points to be relied on by Plaintiff-Appellant on Appeal;

8. Statement of points to be relied on by Defendant-Appellant on Appeal;

9. Complete docket entries;

10. The Opinion of the Court, filed March 18, 1948;

11. The Court's Findings of Fact and Conclusions of Law;

12. Judgment Order of Court;

13. Certificate of Probable Cause;

14. Copies of Notices of Appeal;

15. Bond for Costs of Appeal;



16. Stipulation Extending Time to File Transcripts of Record on Appeals.

17. Stipulation Further Extending Time for Filing Record on Appeal and Docketing Appeal.

Dated: Honolulu, T. H., October 31, 1949.

/s/ RAY J. O'BRIEN,  
United States Attorney, District of Hawaii, At-  
torney for Defendant-Appellant.

SMITH, WILD, BEEBE  
& CADES,

By /s/ MILTON CADES,  
Attorneys for Plaintiff-  
Appellant.

[Endorsed]: Filed November 2, 1949.

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[Title of Court of Appeals and Cause.]

STIPULATION EXTENDING TIME FOR FIL-  
ING RECORD ON APPEAL AND DOCKET-  
ING APPEAL

It is hereby stipulated and agreed by and between the attorneys for the respective parties herein, on the basis of the affidavits attached hereto, that both the Plaintiff-Appellant and the Defendant-Appellant may have to and including the 18th day

of November, 1949 within which to file the record on appeal and docket the appeal.

Dated: Honolulu, T. H., this 31st day of October, 1949.

/s/ RAY J. O'BRIEN,  
United States Attorney, District of Hawaii, Attor-  
ney for Defendant-Appellant.

/s/ MILTON CADES,  
SMITH, WILD, BEEBE  
& CADES,  
Attorney for Plaintiff-  
Appellant.

Approved:

.....,  
Judge, United States Court of  
Appeals, Ninth Circuit.

So Ordered:

/s/ WILLIAM HEALY,  
Chief Judge.

/s/ HOMER T. BONE,

/s/ MARVIN L. POPE,  
United States Circuit Judge.

[Endorsed]: Filed November 4, 1949.

No. 12,391

IN THE

United States Court of Appeals

For the Ninth Circuit

AGNES M. KANNE, Executrix under the  
Will and of the Estate of Fred H.  
Kanne, Collector of Internal Revenue  
of the United States for the District  
of Hawaii, *Appellant*,

VS.

AMERICAN FACTORS, LIMITED (an Hawaiian  
corporation), *Appellee*,  
and

AMERICAN FACTORS, LIMITED (an Hawaiian  
corporation), *Appellant*,

VS.

AGNES M. KANNE, Executrix under the  
Will and of the Estate of Fred H.  
Kanne, Collector of Internal Revenue  
of the United States for the District  
of Hawaii, *Appellee*.

Upon Appeal from the United States District Court  
for the Territory of Hawaii.

FILED

BRIEF FOR APPELLANT,  
AMERICAN FACTORS, LIMITED.

MAR 22 1950

URBAN E. WILD, PAUL P. O'BRIEN

MILTON CADES,

Bishop Trust Building, Honolulu 10, T. H.

*Attorneys for Appellant,*

*American Factors, Limited.*

SMITH, WILD, BEEBE & CADES,

Bishop Trust Building, Honolulu 10, T. H.,



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No. 12,391

IN THE

**United States Court of Appeals  
For the Ninth Circuit**

---

AGNES M. KANNE, Executrix under the  
Will and of the Estate of Fred H.  
Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, *Appellant*,

vs.

AMERICAN FACTORS, LIMITED (an Hawaiian corporation), *Appellee*,

and

AMERICAN FACTORS, LIMITED (an Hawaiian corporation), *Appellant*,

vs.

AGNES M. KANNE, Executrix under the  
Will and of the Estate of Fred H.  
Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, *Appellee*.

Upon Appeal from the United States District Court  
for the Territory of Hawaii.

**BRIEF FOR APPELLANT,  
AMERICAN FACTORS, LIMITED.**

**STATEMENT OF JURISDICTION.**

This is a suit by American Factors, Limited, plaintiff-appellant, against Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, defendant, brought in the United States District Court for the Territory of Hawaii praying for the recovery of additional income taxes and interest thereon for the calendar year 1932, alleged to have been erroneously and illegally exacted from plaintiff by said Fred H. Kanne (Comp. R. 2-48; Ans. R. 48-50). After answer filed, defendant Kanne died and his Executrix, Agnes M. Kanne was substituted as defendant by order of court (R. 51-52).

Jurisdiction of the district court was granted at the time the suit was filed by 28 U.S.C. Sec. 41(5), which as now amended (new 28 U.S.C.) is Sec. 1340.

The judgment of said district court was entered on June 15, 1949 (R. 104-106) pursuant to the opinion of the court filed on March 18, 1948 (R. 59-66) and findings of fact and conclusions of law filed on June 15, 1949 (R. 67-104). Agnes M. Kanne, Executrix as aforesaid, defendant, filed notice of appeal to the United States Court of Appeals for the Ninth Circuit on August 4, 1949. American Factors, Limited filed notice of appeal to the United States Court of Appeals for the Ninth Circuit on August 15, 1949 (R. 108-109). Jurisdiction on appeal is provided in new 28 U.S.C. Sec. 1291.



**STATEMENT OF THE CASE.**

American Factors, Limited, plaintiff-appellant-appellee (hereinafter called "American Factors") is a Hawaiian corporation having its principal office in Honolulu, Territory of Hawaii. Fred H. Kanne was the Collector of Internal Revenue of the United States for the District of Hawaii and a resident of Honolulu at all times from on or about August 1, 1933 until his death on December 24, 1946 (R. 375). Agnes M. Kanne, the duly qualified and appointed executrix of the will and of the estate of Fred H. Kanne, deceased was substituted as defendant in the above cause by order of the district court on March 6, 1947 (R. 375, 50-52).

American Factors, for the purpose of computing its federal income taxes, is and has been at all times on the calendar year and accrual bases, and on the actual method of charging off bad debts (R. 394).

In its federal income tax return (Ex. P-6; R. 209-226) for the taxable year 1932, American Factors deducted the amount of \$568,607.76 of Hackfeld litigation expenses (R. 201, 213, 222) and also the sum of \$50,000.00 on account of a bad debt of Henry Waterhouse Trust Company, Limited written off during the year (R. 213, 394-395) and also \$4,063.33 paid as pensions to widows (R. 97, 418-419) and children of former deceased employees, in computing its taxable net income (R. 201; Ex. P-6, R. 213). The Commissioner of Internal Revenue disallowed the Hackfeld litigation expense as a deduction, the bad debt deduction, and the pension deduction and assessed addi-

tional income taxes on account thereof, which together with interest thereon, American Factors paid to defendant Kanne upon his demand therefor (R. 201-202, 394-396).

The trial court, in its decision, allowed as a deduction \$171,795.26 of the Hackfeld litigation expenses and disallowed the sum of \$396,812.50 of said litigation expenses (R. 59-60, 63-64) and also disallowed the deduction of the bad debt of Henry Waterhouse Trust Company, Limited, but allowed the deduction of the pensions (R. 60-61, 64-65).

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### THE HACKFELD LITIGATION.

When the United States entered the First World War, H. Hackfeld & Company, Limited (hereinafter referred to as "Hackfeld Company"), was a Hawaiian corporation which was then conducting and had conducted for many years past a sugar plantation agency, general merchandise store and other businesses. It was a large factor in the Hawaiian sugar industry and in other businesses in the Territory of Hawaii. It was controlled by German interests. On or about January 28, 1918 and during March 1918, the Alien Property Custodian of the United States of America (hereinafter called the "Alien Property Custodian"), seized the stock of Hackfeld Company owned by German nationals and gained control either directly or indirectly of approximately 68½% of its capital stock (R. 68, 128, 179).

Prior to January 28, 1918, the business of Hackfeld Company had been seriously disrupted as a consequence of the restrictions placed upon it by the allied governments as a result of its German affiliations and those of its stockholders (R. 68, 129, 179-180).

The Alien Property Custodian sought and received the views of leading businessmen interested in the sugar industry and other businesses concerning the Hackfeld Company business (see *Isenberg v. Sherman*, 298 Pac. 1004 at 1011; 212 Cal. 454), and determined that the business should be continued as a unit and as a going concern, and that it must be wholly Americanized (R. 181). A plan for the reorganization of Hackfeld Company was formulated in the office of the Alien Property Custodian, which plan as afterwards perfected was fully set forth in a resolution adopted by the stockholders of the company on July 19, 1918 (R. 68-69, 180). The organization of American Factors, Limited as a new corporation to take over the businesses and assets of Hackfeld Company as a going concern and whose stock or trust certificates therefor were to be sold to American citizens was an integral part of said plan (R. 69, 180). In accordance with the plan, American Factors, Limited was created and had a capital stock of \$5,000,000.00 divided into 50,000 shares of the par value of \$100 each, which shares, pursuant to the plan, were issued to Hackfeld Company and were transferred to trustees to hold until three years after the expiration of the war, and trust certificates representing and entitling the holders thereof to receive all said shares

upon the termination of the trust were sold to bona fide American citizens or American corporations at a price of \$150.00 for each share, or a total stated consideration of \$7,500,000.00 (R. 69, 185).

Some 23 persons and corporations signed a joint subscription agreement under which each individually subscribed for trust certificates representing a certain number of shares of American Factors, Limited (R. 184). This joint subscription was for 27,000 shares, and it was conditioned upon this group collectively being allotted a minimum of 25,000 shares (R. 184-185). The joint subscription was accepted for a total of 25,000 shares and trust certificates were issued to and paid for by the subscribers of the joint subscription for a total of said 25,000 shares (R. 185). Trust certificates representing the other 25,000 shares were issued to and were paid for by approximately 614 other persons and corporations (R. 185). The total stated consideration of \$7,500,000.00 representing the purchase price of the trust certificates for 50,000 shares was duly paid in cash or United States bonds at par to Hackfeld Company and all of its assets and businesses as a going concern were conveyed on August 20, 1918 to American Factors, Limited which assumed all liabilities of Hackfeld Company and of the business, and American Factors, Limited thereafter continued the business as a going concern (R. 185, 197-198).

About June, 1924, the directors of American Factors were informed that former stockholders of Hack-



feld Company, then dissolved, threatened to initiate litigation. At that time it was not known what form the litigation would take nor who would be defendants. The board of directors of American Factors, after consideration, authorized its president to secure counsel for American Factors to prepare for and conduct the defense in the threatened litigation. American Factors procured the services of prominent attorneys to represent it in the threatened litigation (R. 186, 254-255).

Prior to filing of the suits in the threatened Hackfeld litigation hereinafter more fully described, it was rumored that the 23 persons and corporations who had joined in the joint subscription agreement for shares of stock of American Factors were to be charged with fraud and conspiracy in connection with their participation in various capacities and various ways in the reorganization (R. 254-256). Under these circumstances, prior to the filing of any suit, 21 of the 23 (2 being dead) of those persons and corporations who had signed the joint subscription agreement entered into a written agreement dated July 28, 1924 (Ex. 1; R. 202-204), wherein they agreed to pro rate on an original per share basis the expenses of the aforesaid threatened litigation if they were joined as defendants therein. American Factors was not a party to the agreement of July 28, 1924 (R. 186-187).

The suit of J. C. Isenberg, et al., plaintiffs complainants, hereinafter called "Hackfeld plaintiffs" v. George Sherman . . . American Factors, Limited, et



al., defendants respondents, hereinafter called "Hackfeld defendants", and which litigation is herein called the "Hackfeld litigation", was commenced in August and September, 1924. Identical complaints in the Hackfeld litigation were filed in the Circuit Court of the First Judicial Circuit, Territory of Hawaii and in the Superior Court of the State of California in and for the City and County of San Francisco. By stipulation between the parties, the case filed in the California court was tried. American Factors was one of the defendants named in the Hackfeld litigation, and all of the 23 corporations and persons, including the representatives of the estates of the two deceased persons who had signed the joint subscription agreement, were joined as Hackfeld defendants (R. 187).

The Alien Property Custodian was made a respondent but no relief or judgment was sought against him. Certain other persons were made formal respondents alleging that they should have joined as plaintiffs (R. 188-189).

The Hackfeld litigation was brought in equity and the complaint in the action filed in California was entitled "Complaint for Accounting Relief Against Fraud and Conspiracy, for Damages and Incidental Relief." The gist of the complaint affirmed the sale and alleged that the sale and transfer were the result of conspiracy, collusion, and fraudulent connivance on the part of certain respondents whereby they secured the assets and profitable business of Hackfeld Company at a price far below its alleged intrinsic

value in fraud of and to the financial injury of complainants (R. 188). (J. C. Isenberg, et al., plaintiffs-complainants-appellants v. George Sherman . . . American Factors, Limited, et al., defendants-respondents-appellees, reported in 212 Cal. 454-461; 298 Pac. 1004 at 1005-1006.)

The object of the suit was to require respondents to account to complainants for the transfer and sale of the assets of Hackfeld Company to American Factors, Limited and to account for the difference between \$7,500,000.00, the price at which the assets were sold and the actual value of the assets at the date of the transfer which was claimed to be \$17,500,000.00 (R. 188).

The complaint, in paragraph XXXVI thereof, in substance alleged that American Factors, Limited took and received all of the assets of Hackfeld Company with full knowledge of all the facts and circumstances set forth in the complaint and with full knowledge of and concerning the rights and equities of said Hackfeld Company, and did thereafter handle the said assets and conduct the said business in trust for the protection by it of the rights and equities of said stockholders and the complainants and said American Factors did so mismanage said business and did so improperly handle said assets as to cause great damage to said assets and business and great injury to the rights and equities of complainants, and that American Factors was a party to the fraudulent scheme and the conspiracy therein alleged, and holds

tion which totaled \$568,607.76 (R. 198, 260-261). The items of payment and the amounts thereof are shown in the tabulations in Ex. P-7 (R. 261-275).

During the early period of the Hackfeld litigation \$396,812.50 of the litigation expenses were pro rated among 22 of the Hackfeld defendants who were charged with fraud and conspiracy in the litigation proportionately to their original stock subscriptions in American Factors, and these 22 Hackfeld defendants by about the end of the year 1925 or early January, 1926 paid to American Factors sums which totaled said sum of \$396,812.50 on account of litigation expenses (R. 198-200). The question as to whether or not the Hackfeld defendants or American Factors would ultimately pay the expense of litigation was not then determined (R. 205, 280-283, 289).

The case went to trial and was on trial in the Superior Court of California at San Francisco for some 112 days of taking evidence. At its conclusion, the trial judge filed a terse memorandum as follows (R. 193):

(Memorandum, January 6, 1926; *Isenberg v. Sherman*, 212 Cal. 454, 461; 298 Pac. 1004-1007.)

"I am of the opinion that (1) no actual fraud on the part of respondents was shown; (2) no constructive fraud existed; (3) the price paid was adequate; (4) the suit is not barred by the Hawaiian statute of limitations; (5) plaintiffs were not guilty of laches. Frank J. Murasky, Judge." (R. 193.)

On March 16, 1926, a decision comprising Findings of Fact and Conclusions of Law was filed and on January 31, 1927 judgment was entered for the defendants and against the complainants (R. 193).

The Hackfeld plaintiffs perfected an appeal to the Supreme Court of the State of California where further hearings and arguments were had in the matter on appeal, and on April 30, 1931 the California Supreme Court rendered its opinion affirming the judgment of the trial court. This opinion is reported in 212 Cal. 454, 298 Pac. 1004. On May 28, 1931, the Supreme Court of California denied a petition for rehearing filed by Hackfeld plaintiffs. This opinion is reported in 212 Cal. 507; 299 Pac. 528. Thereafter, a motion to recall the remittitur issued to the County Clerk of San Francisco was filed by the complainants on August 26, 1931, and the Supreme Court of California in a decision handed down on January 29, 1932 denied plaintiffs' motion to recall the remittitur. (See 214 Cal. 722; 7 P. (2d) 1006.) On April 25, 1932 the Supreme Court of the United States denied a petition filed by the Hackfeld plaintiffs for a writ of certiorari to the Supreme Court of California, 286 U.S. 547 (R. 193-194).

Mr. Allen W. T. Bottomley reported to the stockholders of American Factors on the Hackfeld litigation at their annual meeting after the final decision of the California Supreme Court in 1932. He was at that time president of American Factors. He was joined as one of the defendants charged with fraud



in the suit and signed the agreement on July 28, 1924 (Ex. P-5, Ex. 1; R. 202-204). This exhibit shows that he had originally subscribed for 1,000 shares of stock of American Factors. He was a member of the steering committee named in Ex. P-5, Ex. 1 (R. 202-204, 256). As one of those charged with fraud and conspiracy, he had advanced sums which totaled \$17,500.00 on account of legal expenses (R. 200). The records of that stockholders' meeting quote Mr. Bottomley as stating:

"I should like to refer to the paragraph in my report which deals with the case of Isenberg et al. versus Sherman et al., or the so-called Hackfeld litigation, the expenses of which have been advanced by certain of the individual defendants pending the decision of the Court as to whether their acts were legal and the transaction a valid one. These defendants, as officers and large stockholders, participated in the organization of American Factors, Limited, and were made codefendants with American Factors, Limited in the litigation.

"The litigation in California, as you all know, complained of the acts of these individual defendants, as well as the acts of American Factors, Limited, in connection with the reorganization of Hackfeld & Co. and the organization of American Factors, Limited, . . ." (Ex. P-5, Ex. 2; R. 205).

He further stated:

". . . that the defendants in the suit were attacked solely because they had assisted in the formation of American Factors, Limited. Accord-



ingly, I recommend to this meeting of Stockholders that they approve of the payment by the Company of the litigation expenses rather than have them remain as a charge against those who, under the direction of the Alien Property Custodian, were responsible for the formation of the Company.

“The Undivided Profits and Reserves of Hackfeld & Co. standing on the books of that Company as of August 18th, 1918, the date on which Hackfeld & Co. was taken over by the American Factors, Limited, were set aside as a reserve to meet any contingent claims on American Factors, Limited, or unknown liabilities of Hackfeld & Co., and I believe that the balance of this reserve could justly and properly now be used in the payment of these expenses so that the actual earnings of the Company would not be affected thereby.” (R. 206.)

President Bottomley stated further that this matter was taken up with Mr. Oscar Sutro, attorney for the company during the litigation, and that he feels that the whole structure of the company was involved in the claims made by Mr. Nylen and that the litigation expenses should be paid by the company (R. 206).

After this report, on motion duly made and seconded, the stockholders adopted a resolution authorizing the corporation to pay all the costs and expenses of the Hackfeld litigation (excerpt from minutes R. 207). Pursuant to the authorization, the board of directors authorized the corporation to make the payment.

In the year 1932, after the conclusion of the Hackfeld litigation, American Factors repaid the said sum of \$396,812.50 to the 22 stockholders (including the heirs of a deceased stockholder) who had been charged with fraud and conspiracy and who had contributed to the payment of such sum on account of the Hackfeld litigation expenses (R. 201).

The other approximately 614 original stockholders of American Factors, Limited paid no part of the Hackfeld litigation expenses (R. 185, 198-201). The trial court in the Hackfeld suit in its findings found that the 22 defendants charged with fraud and conspiracy did not reap any benefits from the reorganization or from the sale of stock of American Factors or the trust certificates therefor or from the purchase thereof by themselves, except such benefits as accrued to every purchaser of said trust certificates (R. 197).

In 1932, after the final conclusion of the Hackfeld litigation, all of the litigation expenses totaling \$568,607.76 were charged against the balance credit in the general reserve account of \$541,237.79 which was carried over by American Factors from Hackfeld Company, which wiped out this reserve account, and the \$27,369.97 necessary to make up the balance of the cost of litigation was charged against earned surplus (R. 289-291, 310).

**THE HENRY WATERHOUSE TRUST COMPANY,  
LIMITED LOAN.**

American Factors, at the end of the calendar year 1930, had a capital of \$10,000,000.00 and its books showed a surplus and undivided profits of \$5,971,049.93, or a total capital and book surplus of \$15,971,049.93. At the end of the calendar year 1930, and during the entire calendar year 1931, American Factors was agent for thirteen sugar plantations and other corporations located in and carrying on business in the Hawaiian Islands, which corporations had a total capital of \$26,944,720.00, a total surplus and undivided profits of \$21,411,420.24, or a total capital and surplus as of December 31, 1930 of \$48,356,140.24. On December 30, 1930, American Factors and the companies for which it served as agent had on deposit in the banks of the Territory of Hawaii at least a total sum of \$1,741,696.24 (R. 376).

The Henry Waterhouse Trust Company, Limited, herein called "Waterhouse Company", was incorporated under the laws of the Territory of Hawaii on November 26, 1902, to engage in the business usual and permitted to a trust company under the laws of the Territory. In addition to usual fiduciary business common to trust companies, it operated a plantation agency department, a real estate department, a stock and bond brokerage department, and an insurance department and at times invested in stocks and bonds to a limited extent on its own account (R. 376-377).

In the middle of October, 1930, Waterhouse Company increased its capital stock from \$200,000.00 to

\$400,000.00 consisting of 4,000 shares of a par value of \$100.00 each. The new shares were all taken by the old stockholders who paid for them in cash at par. In November, the effects of the general business depression began to be felt in the Territory, and as a large part of the Waterhouse Company assets consisted of real estate and mortgages, its secretary became apprehensive that if many calls were made on its demand accounts, the company's financial condition would not be sufficiently liquid to meet its cash requirements. He discussed the situation with the treasurer and auditor of the Waterhouse Company and advised the management of Bishop Trust Company, Limited, herein called "Bishop Trust" that a sale of the stock might be arranged, suggesting a price of \$100.00 each or more for the shares (R. 377).

Late in November, 1930, Mr. Allen W. T. Bottomley who was president of American Factors and of Bishop First National Bank of Honolulu, and vice president and director of Bishop Trust called Mr. E. J. Greaney, an auditor, to his office and informed him that circumstances required that a confidential examination be made of the books and accounts of Waterhouse Company (R. 488). Mr. Bottomley informed Mr. Greaney that the balance sheet and statements of the Waterhouse Company indicated that the receivables or a substantial part of the assets were somewhat frozen and that if demand were made for payment of the large deposit accounts, the company would have difficulty meeting the demands because of the shortage of cash and the frozen condition of a substantial part of



the receivables (R. 489). Mr. Greaney was employed to make an audit under the circumstances. Mr. Greaney entered upon the work and as a part of it, together with others, from time to time made an exhaustive appraisal of the then value of the various types of receivables (R. 489-492, 499-500, 502-505).

Mr. Allen W. T. Bottomley called a conference of the heads of the three Hawaiian sugar agencies, the president of the Bank of Hawaii, Limited, the president of the Hawaiian Trust Company, Limited and two members of the finance committee of Bishop Trust to present to them the financial condition of the Waterhouse Company and discuss the feasibility of making some plan to prevent the Waterhouse Company from being forced into liquidation (R. 379).

The Waterhouse Company was conducting business as usual (at the end of 1930 and early in 1931), but was encountering some financial difficulties. Economic conditions were not clear, and after the investigation, the executives of Bishop Trust wished to look further into the matter before acting. After February 1, 1931, Bishop Trust advised Waterhouse Company shareholders that it would not pay cash for their shares (R. 380-382).

Mr. Greaney testified that a figure of \$260,000.00 was added to the estimated losses determined in the appraisal referred to above (R. 496). He stated that this \$260,000.00 represented a cushion in effect and had the effect of being a cushion to take care of any losses over and above the amount that was put in the loss



column on the schedule that was prepared covering the individual receivables that were on the books (R. 497-498).

He further stated that the loss estimate was increased by \$260,000.00 when Bishop Trust refused to pay anything for the stock of Waterhouse Trust and that this was done "so that the reserve for contingencies was made to balance up so that it would appear proper to pay nothing for the stock" (R. 498).

An audit report dated March 31, 1931 signed H. C. Tennent and Co. by E. J. Greaney disclosed the book value of assets of the Waterhouse Company as of February 14, 1931, to be in the amount of \$4,820,090.92, and the liabilities, exclusive of capital and surplus, to be in the amount of \$4,149,437.06 (R. 377-378).

The audit report stated that the contingent reserve for losses of \$680,803.15 and the special contingent reserve of \$400,000.00 were considered adequate to cover probable losses in the realization of assets and liquidation of liabilities (R. 378).

On Saturday, February 14, 1939, the president of Bishop Trust at a meeting of the Board of Directors of that company made a statement which was recorded on the minutes (R. 380-382). The plan outlined in this statement in brief was that Bishop Trust would acquire the stock of Waterhouse Company without cost; for Mr. and Mrs. R. W. Shingle in settlement of their indebtedness to the company to pay to it \$535,000.00 and to convey their respective 18% and 10% undivided interests in certain lands, the same to be sold for

\$87,000.00 and the proceeds with \$13,000.00 additional to be contributed by Bishop Trust to make up an even \$100,000.00 to be paid into Waterhouse Company (R. 380-382).

In addition, a number of corporations and individuals were to loan various sums aggregating \$400,000.00 and receive notes therefor (Ex. J; R. 410), thus making \$1,035,000.00 of cash to be paid into Waterhouse Company. Bishop Trust was to pay such amount, if any, as might be required in addition to enable the Waterhouse Company to meet its liabilities, but it was hoped that no such contribution would be required. Bishop Trust was to take over, without other cost, the business of Waterhouse Company, other than assets and liabilities, and to operate such business at its own expense and for its own benefit, which included trusts, executorships, agencies, insurance, safe deposit business, etc., with the necessary furniture and equipment and supplies therefor (R. 380-382).

The plan was that the assets and liabilities were to be liquidated by applying the assets to the liabilities and in final settlement, if there was an excess of assets over liabilities, it was to be applied first to the reimbursement of the amount contributed by Bishop Trust, if any, in addition to the \$1,035,000.00 and secondly, pro rata to the lenders of the \$400,000.00 with interest at 4% and thirdly the balance, if any, to go to Bishop Trust Company, Limited (R. 382).

American Factors and each of the persons lending money to the trust company under this agreement received notes which were identical in form. A true

copy of the note delivered to American Factors is shown in Ex. J (R. 410).

Letters showing the basis of the borrowings are shown as Exs. H and I (R. 402-409).

Sherwood M. Lowrey, the treasurer of American Factors, testified that he had conferred with Mr. Bottomley, the president, about the loan at the time it was made, and that Bottomley stated that it was to the best interests of the community and of American Factors to make the loan, and that "if the money was so loaned, there is a perfectly reasonable chance of getting the money back" (R. 473-474). The note (Ex. J., R. 410) was set up on the books of American Factors as a perfectly good asset (R. 474).

Mr. A. L. Castle who was a stockholder of Waterhouse Company (R. 507) testified that he thought the loan to Waterhouse Company was a good loan (R. 511) and that his father made the loan.

Mr. Arthur L. Dean testified on behalf of one of the lenders, Alexander and Baldwin, Limited, that at the time the loan to Waterhouse Company was made, they expected to get all or part of the money back again, but the stake in preserving the company was sufficiently large so that they were prepared to make the loan (R. 532).

The Bank Examiner's report which was made as at December 31, 1932, stated that:

"The records of the Henry Waterhouse Trust Company, Limited, show that subsequent to February 14, 1931, and shortly after the company was taken over by the Bishop Trust Company,

Limited, sufficient assets appeared to be on hand to meet all liabilities of the company. . . ." (R. 554).

An advisory committee of the lenders was appointed to pass upon the program of liquidation and the members of the advisory committee are shown at R. 388-389.

Mr. S. M. Lowrey, plaintiff's treasurer, was alternate member for Mr. Bottomley. This committee met frequently with the financial committee of the Waterhouse Company and passed upon all matters of importance, and particularly those matters tending to affect the amount of reimbursement, if any, ultimately to be made to the special note holders (R. 390).

Under date of July 18, 1932, Waterhouse Company, over the signature of M. B. Henshaw, dispatched to the plaintiff a letter (a true copy of which marked Ex. M is shown at R. 413-414) stating that early in 1932, the advisory and finance committee of Waterhouse Company decided that it was advisable to reappraise the assets and that an exhaustive reappraisal disclosed that its liabilities other than those to the lenders and stockholders exceeded the value of the assets by a very considerable amount, and advised them that the note had now become worthless (R. 413-414).

S. M. Lowrey, the then treasurer of American Factors, testified that he reviewed the note again at the end of the calendar year 1931 and that he considered that it was a good note at that time and no reserve was created (R. 466). It was a part of his duties as treasurer to review each year all the receivables and reap-



praise them (R. 466-467). He had seen the letter of July 18, 1932 referred to hereinabove, that he was on the advisory committee as Mr. Bottomley's alternate and he knew what procedure that committee followed in determining the value of the assets, and that after receiving the letter, he went into the thing more thoroughly than ever before and consulted with Mr. Henshaw and Mr. Linden of Alexander and Baldwin; that he went into the question of the assets that remained to be liquidated (R. 468). He came to the conclusion by the end of the year 1932 that the note was valueless and in order to get a proper balance sheet, he wrote it off and also claimed it as a tax deduction (R. 468).

The Bank Examiner of the Territory of Hawaii completed an examination of the condition and affairs of Waterhouse Company as at December 31, 1932, and stated of the company's condition as at that time: "An analysis of the various asset and liability accounts of the company made by us as at December 31, 1932, disclosed, according to our figures, an insufficient amount of assets to meet the remaining liabilities." (R. 554).

The third paragraph of the Bank Examiner's report states that contingent reserve and capital are entirely absorbed and that Bishop Trust Company, Limited, advances to an amount of \$255,215.61 were used to meet estimated losses (R. 554-555). In brief, the Bank Examiner's report after revaluing assets as at December 31, 1932, showed the notes of the corporations and persons who loaned Waterhouse Company \$400,000.00 were valueless as at December 31, 1932.



**QUESTIONS OF LAW INVOLVED.**

(1) Is American Factors entitled to a deduction of \$396,812.50 of Hackfeld litigation expenses, reimbursed to its co-defendants in the year 1932, as an ordinary and necessary expense of carrying on its business, in the computation of its federal income tax liability for the year 1932?

(2) Is American Factors entitled to a deduction of the amount of \$50,000.00, advanced by it to Waterhouse Company and charged off as worthless in the year 1932, as a bad debt, as an ordinary or necessary expense of carrying on its business, or as a loss sustained in the year 1932, in the computation of its federal income tax liability for the year 1932?

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**SPECIFICATION OF ERRORS RELIED ON.**

The United States District Court for the Territory of Hawaii erred:

(1) In concluding that American Factors is entitled to a deduction of only \$171,795.26 instead of \$568,607.76 of the Hackfeld litigation expenses as ordinary and necessary expenses paid or incurred during the taxable year 1932;

(2) In concluding that \$396,812.50 of the Hackfeld litigation expenses, which American Factors refunded or repaid in the year 1932 to persons and corporations who were co-defendants with American Factors in said litigation, were not ordinary or necessary expenses paid or incurred during the year 1932;

(3) In failing to find and hold that the Commissioner of Internal Revenue erred in disallowing American Factors a deduction of \$568,607.76 of the Hackfeld litigation expenses in computing its net taxable income for the year 1932;

(4) In concluding that there was no legal obligation or liability on the part of American Factors to reimburse or refund to its stockholders who were co-defendants with it in the Hackfeld litigation, the sum of \$396,812.50 which American Factors repaid to them in 1932;

(5) In failing to find and hold that even in the absence of any legal obligation or liability on the part of American Factors to reimburse or refund to its stockholders who were co-defendants with it in the Hackfeld litigation, the refund or repayment to them was nevertheless an ordinary and necessary expense of American Factors paid or incurred during the year 1932;

(6) In concluding that the payment of \$50,000.00 to Waterhouse Company in 1931, by American Factors, was just a contribution;

(7) In concluding that the note given by Waterhouse Company, in 1931, to American Factors, was contingent in payment; was subject to such conditions as to render it nonnegotiable, and was without any negotiable value at the time it was made and at all times thereafter;

(8) In concluding that the note given by Waterhouse Company, in 1931, to American Factors, could not be dealt with as a debt;

(9) In concluding that the contingencies as to payment and/or the lack of negotiable value prevented said note from being evidence of a debt;

(10) In concluding that the Commissioner of Internal Revenue did not err in disallowing American Factors a deduction therefor as a bad debt in computing its taxable net income for the calendar year 1932;

(11) In concluding that no part of the payment of \$50,000.00 made to Waterhouse Company in 1931 by American Factors was deductible as a bad debt ascertained to be worthless and charged off within the tax year 1932, or as a loss sustained during that taxable year;

(12) In failing to render judgment in favor of American Factors for the amount of \$97,134.90 instead of the amount of \$31,691.18 on account of American Factors' overpayment of income tax for the year 1932.

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## SUMMARY OF ARGUMENT.

### I.

THE COURT ERRED IN DISALLOWING THE DEDUCTION BY AMERICAN FACTORS OF \$396,812.50 OF HACKFELD LITIGATION EXPENSES REIMBURSED TO OTHER DEFENDANTS AS AN ORDINARY AND NECESSARY EXPENSE IN COMPUTING ITS TAXABLE NET INCOME FOR THE CALENDAR YEAR 1932.

The court correctly held that the full amount of the Hackfeld litigation expense is an ordinary and neces-

sary business expense, all of which accrued for income tax purposes in the year 1932, but erred in holding that American Factors cannot deduct the portion thereof which it reimbursed to the co-defendants in that litigation.

- (A) The co-defendants in the Hackfeld litigation did not voluntarily pay the expense of litigation without expectation of reimbursement in the event that they were freed of charges of fraud and conspiracy upon the final determination of the litigation.

The court erred in holding that the co-defendants in the Hackfeld litigation voluntarily paid the expense of litigation without expectation of reimbursement or demand therefor after successful determination of the litigation in 1932. Actually, the agreement among the co-defendants was that among themselves they would pay their pro rata share of the litigation expense on the basis of original shareholdings, but, as between the group of co-defendants and American Factors, the determination as to which was to bear the ultimate expense of litigation was dependent on the final determination of the litigation. Even in the absence of any agreement, if the co-defendants were finally adjudged guilty of fraud or conspiracy, they, and not American Factors, would have been liable for the costs of litigation. In addition, a request for reimbursement was made on behalf of the co-defendants.



- (B) Once the litigation charging the co-defendants with fraud and conspiracy had been finally concluded holding that they were not guilty of any fraud or conspiracy, then American Factors for the first time became bound to pay the litigation expenses and to reimburse the co-defendants for the expenses paid by them which amounted to \$396,812.50.

Upon the successful termination of the litigation in 1932 holding that the co-defendants were not guilty of fraud or conspiracy, there was created an absolute legal liability of American Factors for the payment of all the litigation expense. This liability arose by the conferring of benefits on the corporation by this group of co-defendants for the benefit of American Factors, thereby setting up a right of reimbursement out of the fund protected. Also, the liability arose under the doctrine of restitution, and is founded as well on the law of agency. Further, even if there were only a moral obligation on American Factors to reimburse its co-defendants, that would be sufficient to entitle American Factors to the deduction of the amounts paid as ordinary and necessary expenses.

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## II.

THE COURT ERRED IN DISALLOWING AMERICAN FACTORS THE DEDUCTION OF THE PAYMENT OF \$50,000.00 TO WATERHOUSE COMPANY IN 1931 IN COMPUTING ITS TAXABLE NET INCOME FOR THE CALENDAR YEAR 1932.

- (A) The sum of \$50,000.00, representing the amount paid to Waterhouse Company in 1931, was deductible as a bad debt, determined to be worthless and charged off within the tax year 1932.

American Factors did not intend to make a gift or contribution to Waterhouse Company. The money



advanced constituted a loan which was to be repaid from the liquidation of the assets of Waterhouse Company, and there was full expectation that the note would be repaid. It was only when business conditions in the community took an unexpected turn for the worse that the note was ascertained to be worthless and charged off.

(B) If not deductible as a bad debt, the sum of \$50,000.00, representing the amount paid to Waterhouse Company in 1931, was deductible as a loss sustained, or as an ordinary and necessary expense of American Factors in 1932.

Despite the court's holding, there was evidence that American Factors would incur a loss if Waterhouse Company were allowed to fail. In addition to the direct evidence, the court may take judicial notice of the precarious condition of financial institutions all over the country at the time, and may consider the statement of the Tax Court in previously reported opinions relating to the same transactions.

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## ARGUMENT.

### I.

THE COURT ERRED IN DISALLOWING THE DEDUCTION BY AMERICAN FACTORS OF \$396,812.50 OF HACKFELD LITIGATION EXPENSES REIMBURSED TO OTHER DEFENDANTS AS AN ORDINARY AND NECESSARY EXPENSE IN COMPUTING ITS TAXABLE NET INCOME FOR THE CALENDAR YEAR 1932.

*Section 23 of the Revenue Act of 1932* providing for the deduction of ordinary and necessary expenses of corporations is as follows:

“Sec. 23. DEDUCTIONS FROM GROSS INCOME.

“In computing net income there shall be allowed as deductions:

“(a) EXPENSES.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . .”

The Hackfeld litigation, while in equity, claimed damages for fraud and conspiracy of the directors and stockholders who had participated in the reorganization of Hackfeld Company into American Factors. It affirmed the sale and transfer of the assets of Hackfeld Company and alleged that the sale and transfer (of said assets and businesses) were the result of conspiracy, collusion and fraudulent connivance on the part of the defendants whereby they caused to be sold to American Factors at a price far below its alleged intrinsic value these assets (R. 72).

Every act done which petitioners in the Hackfeld litigation contend was fraudulent or conspiratorial was done in and about and pertaining to this reorganization (R. 72).

If these persons and corporations (hereinafter called the “co-defendants”) were found guilty of fraud and conspiracy as between themselves and American Factors, the obligation to pay all litigation expenses as well as the damages assessed was theirs rather than American Factors’. Had the co-defendants been held guilty of fraud and conspiracy in the reorganization of Hackfeld Company into American Factors as between American Factors and these co-

defendants charged, American Factors would have a good cause of action against them for all of the damages caused by their tortuous acts. *Blackwell Oil & Gas Co. v. Commissioner of Internal Revenue*, 60 F. (2d) 257.

In June, 1924, when the directors of American Factors were informed that the former stockholders of Hackfeld Company threatened to initiate litigation, although it was not known what form the litigation would take, nor who would be the co-defendants, American Factors engaged the services of attorneys to represent it in the threatened litigation and to prepare for and conduct the defense (R. 186). Before the suits were filed, twenty-one of the twenty-three persons and corporations (two having died) who had joined in the joint subscription for the shares of stock of American Factors at the time of its organization, entered into a written agreement, to which American Factors was not a party, wherein they agreed to prorate, on an original per share basis, the expenses of litigation if they were joined as co-defendants therein (R. 186-187).

When the suits were started, all twenty-one living, and the estates of the two who had died, of those who had signed the original joint subscription agreement were joined as co-defendants (R. 187). American Factors paid from time to time all the expenses of the Hackfeld litigation, which totaled \$568,607.76, which payments were carried on its records as deferred items. During the earlier period of the litigation \$396,812.50 of the above expenses was prorated

among twenty-two of the co-defendants in accordance with the agreement, and American Factors collected that amount from them (R. 198-200). This method of handling the litigation expense was in accordance with the instructions given by the president of American Factors to the treasurer, namely, to keep track of all expenses paid; that the group of co-defendants were to be billed an amount to cover their pro rata shares; that the account was to be carried in this manner and eventually it would be decided, after the suit had been determined, as to who would ultimately bear the expense of the litigation (R. 280). The determination as to who would ultimately bear the expense depended on whether the court determined whether the acts of the individual co-defendants were legal and the transactions were valid. These defendants were officers and large stockholders who participated in the organization of American Factors and who were attacked solely because they assisted in the formation of American Factors (R. 205-206).

The Hackfeld litigation was concluded in 1932 (R. 60, 77, 78) making final the determination of the trial court that there was no actual or constructive fraud and that the transactions involving the organization of American Factors and its purchase of the business of Hackfeld Company was a valid one, and with the finding that none of the co-defendants reaped any benefit from said reorganization or the sale of stock of American Factors or the purchase thereof by themselves, except such benefits as accrued to every purchaser of said certificates (R. 75, 77).



The co-defendants having been freed of any claim of fraud, A. W. T. Bottomley, one of the co-defendants, sought the opinion of attorney Oscar Sutro as to whether American Factors should pay the litigation expense. It was the opinion of said counsel that American Factors should pay all of the litigation expenses (R. 206). Other counsel, who had been asked only the questions whether the payment would be *ultra vires* and if American Factors was morally obligated to pay said expenses, advised that it was within the power of the corporation to reimburse the expenses paid by other co-defendants and that the corporation is under moral obligation to make such reimbursement (R. 206-207; Ex. P-10, R. 347, 355).

Mr. Bottomley, president of American Factors, who was one of the members of the steering committee and the owner of 1,000 shares, and who had paid in \$17,500.00 of the litigation expenses as his pro rata share, stated, at the annual meeting of stockholders held in March, 1932 that the expenses of the Hackfeld litigation had been advanced by certain of the individual co-defendants pending the decision of the court as to whether their acts were legal and the transaction a valid one; that these co-defendants as officers and large stockholders participated in the organization of American Factors and were made co-defendants with American Factors in the litigation (R. 205), and that the co-defendants in the suit were attacked solely because they had assisted in the formation of American Factors, and he recommended that the meeting of stockholders approve of the payment of



the litigation expenses (R. 206), and upon resolution duly adopted, the stockholders unanimously voted that the co-defendants be reimbursed the amount advanced by them (R. 207).

The gist of the holding of the court with relation to the portion of the Hackfeld litigation expenses reimbursed to the co-defendants as set out in the decision (R. 62-64), the opinion (R. 59-60), the findings of fact (R. 67-79) and the conclusions of law (R. 100-102), is that although the full amount of the litigation expense is an ordinary and necessary expense, all of which accrued for income tax purposes in the year 1932, nevertheless, American Factors is not the person entitled to the deduction therefor. (R. 59-60, 62-64, 77-79, 100-102).

The determination of the court that the Hackfeld litigation expenses are ordinary and necessary business expenses is fully supported by the authorities. *Commissioner of Internal Revenue v. Heininger*, 320 U.S. 467, 88 L. ed. 171; *Welch v. Helvering*, 290 U.S. 111, 78 L. ed. 212; *Kornhauser v. United States*, 276 U.S. 145, 72 L. ed. 505; *Rassenfoss v. Commissioner of Internal Revenue*, 158 F. (2d) 764.

That the court correctly ruled that all the litigation expenses accrued in 1932, regardless of the time of payment, is also in accord with the authorities, it being well settled that a liability does not accrue until all the events occur that fix the amount and the fact of liability. *Dixie Pine Prod. Co. v. Commissioner of Internal Revenue*, 320 U.S. 516, 88 L. ed. 270;

*Security Flour Mills Co. v. Commissioner of Internal Revenue*, 321 U.S. 281, 88 L. ed. 725; *Baltimore & Ohio R. Co. v. Magruder*, 174 F. (2d) 896.

This conclusion is based on the facts stated by the court that the co-defendants, other than American Factors, entered into an agreement among themselves to pay pro rata on the basis of the stock for which they originally subscribed, the litigation costs of the suit (R. 60), that the persons who subscribed to pay voluntarily for the defense were motivated by personal interests and desires to clear themselves as defendants against claims that they had unlawfully conspired and acted in fraud and for the purpose of escaping a liability in damages by a possible judgment against them and to protect their individual investments as stockholders in the corporation (R. 62); that they made the payments without promise or original expectation of reimbursement at the time of the contribution; that they made no demand or test of their right to be reimbursed for the expenses paid; that the act of American Factors in reimbursing them flowed from feelings of gratitude, and the liberal aid of the contributors and their steering committee contributed many facilities and influences such as could not have been supplied by the management of American Factors acting alone (R. 62, 65, 77-79).

However, the court did hold that American Factors had very substantial interests to protect and was justified in every way, as a legitimate business outlay, in paying from its own funds during the tax year

1932, or earlier years had it chosen to do so, the costs of litigation which imperiled its existence, although others were involved in the same litigation as defendants and had much to lose (R. 63, 79), that it was only because others had come forward with the funds and volunteered to engineer and fight the battle at their own cost that American Factors was not justified in deducting from its taxable income the money it paid to reimburse those who contributed the money for the defense of the litigation even though the victory brought great benefit to American Factors as well as the co-defendants (R. 63-64, 79).

The court further found that it had been established in the Hackfeld litigation that the co-defendants did not reap any benefit from the reorganization or from the sale of the stock of American Factors or from the purchase thereof by themselves, except such benefits as accrued to every purchaser of the stock (R. 77). There were 615 other original stockholders who were not made co-defendants in the Hackfeld litigation who paid nothing into the litigation fund (R. 60).

From the holdings of the court, it became apparent that the court erred in holding that American Factors could not reimburse the co-defendants for the amounts advanced by them as litigation expense and deduct the same as litigation expense in the year in which the litigation was concluded and the liability for the expenditure of the litigation expense became certain.

The court, in finding that there was a voluntary payment by the co-defendants, appears to have misconstrued the agreement among them. All of the co-defendants were in the same position, and as the court found, were only made co-defendants because they actively participated in the transactions out of which American Factors was organized. As such, their only benefits were by reason of their participation and could be measured pro rata according to the number of shares of American Factors which they acquired. Accordingly, they agreed among themselves that if joined as defendants, they would share the costs pro rata according to the number of shares of stock subscribed for and issued to each, and that is the sole purpose of their agreement. As between them, as a group, and American Factors, there was no agreement at that time as to who was ultimately to bear the expenses, but, as stated by A. W. T. Bottomley, who was one of the co-defendants and a member of the steering committee, the question as to whether American Factors or the co-defendants were to bear the litigation cost was one that was left to be determined after the case had been decided and a determination made by the court as to whether the co-defendants were or were not guilty of fraud and conspiracy.

It is the contention of American Factors that, first, there was no voluntary payment of litigation expenses by the co-defendants, but merely machinery set up under which those persons who performed the very acts for which the co-defendants and American Factors were being sued would share the litigation ex-



pense in an equitable manner among themselves until it was determined that they were not guilty of any fraud or conspiracy; second, once it had been determined that the persons acting on behalf of American Factors were not guilty of fraud and conspiracy, as between them as a group and American Factors, American Factors was bound to pay all the litigation expenses and to reimburse the amounts advanced by these co-defendants.

- (A) The co-defendants in the Hackfeld litigation did not voluntarily pay the expense of litigation without expectation of reimbursement in the event that they were freed of charges of fraud and conspiracy upon the final determination of the litigation.

As pointed out above, the co-defendants agreed among themselves that, until such time as they were cleared of fraud and conspiracy, they would pay the costs pro rata, according to the number of shares of stock subscribed for and issued to each. As far as American Factors was concerned, no agreement was made with it, but its role was to act as the banker for the group of co-defendants; to pay the costs in the first instance with the approval of the steering committee, to keep record of such expenses with the determination as to who was to ultimately bear the costs of the litigation dependent upon the final determination of the litigation.

In 1932, the year in which the Hackfeld litigation was finally determined, A. W. T. Bottomley, who was a member of the steering committee, who had been an original subscriber for shares of stock, and who



had paid \$17,500.00 toward the cost of the litigation expenses, stated the gist of the understanding between American Factors and the co-defendants and requested and strongly recommended the reimbursement of the litigation expenses to the co-defendants.

He also stated that he had received the opinion of Oscar Sutro, the principal counsel for the co-defendants, that under the circumstances of this litigation, American Factors was liable for the payment of the costs thereof.

Furthermore, until it had been determined that the co-defendants were not guilty of fraud and conspiracy, American Factors was under a duty not to pay the litigation expenses incurred in defense of the suit.

It is clearly settled law that if the co-defendants had been guilty of fraud, even in actions purporting to be for the benefit of American Factors, such defendants, and not American Factors, would have been obligated to pay the entire costs of the litigation. In *Blackwell Oil & Gas Co. v. Commissioner of Internal Revenue*, 60 F. (2d) 257, the taxpayer claimed the deduction, as a business expense, of an amount which it had paid in settlement of a suit which was predicated upon an alleged conspiracy entered into between the defendants in the action as directors of the corporation. The court stated at page 258:

“ . . . The defendants in the action, as directors of the corporation, *had no authority to enter into any unlawful conspiracy.*<sup>1</sup> While the alleged acts

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<sup>1</sup>Emphasis supplied.

committed in furtherance of the conspiracy were largely acts committed by the defendants as officers and directors of the corporation, the gist of the action was a conspiracy. It seems clear to us that the *petitioner was not liable for the cause of action compromised and the amount paid in compromise was neither an ordinary or necessary expense of the corporation . . .*"<sup>1</sup>

If the court had held in the Hackfeld case that the officers and stockholders of the corporation, who had acted as agents and officers in performing the acts complained of, had been guilty of performing fraudulent and improper acts, these co-defendants would not, as agents, officers or directors or otherwise, have had any authority from American Factors to enter into such conspiracy to defraud or to perform the fraudulent acts complained of. Upon such a holding, American Factors would disavow any liability for the other co-defendants' acts and would not, as between itself and the other co-defendants, be legally liable for the expenses of defending the litigation.

**(B)** Once the litigation charging the co-defendants with fraud and conspiracy had been finally concluded holding that they were not guilty of any fraud or conspiracy, then American Factors for the first time became bound to pay the litigation expenses and to reimburse the co-defendants for the expenses paid by them which amounted to \$396,812.50.

As the court finally determined that there was no fraud and no conspiracy, and as all acts complained of were for the benefit of and done in connection with American Factors' business, there was an absolute legal liability upon American Factors to pay all of

the costs of defending such litigation. A corporation is liable for and may employ its funds in the defense of legal proceedings even though brought against the officers or members of its committees, etc., where it has an interest in and is affected by the litigation. See *Fletcher Cyclopedia Corporations, Permanent Edition*, Sec. 2507.

That this is so, the court recognized in its holding in effect that the litigation expenses were ordinary and necessary business expenses and would have been deductible at the final conclusion of the litigation if they had not been voluntarily paid by the co-defendants.

In *Mitchell v. Beachy*, 110 Kans. 60, 202 Pac. 628, it was held that a corporation had a duty to keep its stock records straight and accurate and, consequently, it could lawfully pay and had a legal obligation to pay all of the attorneys' fees for defending a suit brought against the cashier of the bank personally, and also the bank, in which such matter was involved. In that case, as in the present one, there were other parties than the defending corporation, and the decision of the court sustained as proper the payment of the whole fee for the defense of all parties named as defendants in the suit.

In the present case, the final determination as to who was legally obligated for the payment of the expense of the litigation, as between the co-defendants and American Factors, could not be made until the litigation itself was terminated, which was in 1932, at

which time, for the first time, it was definitely determined that American Factors was legally obligated to pay all the expenses of litigation, and this is true even though the other co-defendants were joined in the litigation.

It is also a well-established rule that any one person or persons who, having an interest in a trust fund (or having an interest in a corporation) at his or their own expense takes proper proceedings to save the funds from destruction or to restore the funds, is entitled to reimbursement either out of the fund itself or from proportional contribution from those who accept the benefit of his efforts. *Trustees of the Internal Improvement Fund v. Greenough*, 105 U.S. 527, 26 L. ed. 1157; *Sprague v. Ticonic National Bank*, 307 U.S. 161, 83 L. ed. 1184. This is an old established rule of chancery under which all the persons who benefit bear the expenses incurred in obtaining or preserving the benefit for the common good.

In the present case, only twenty-three of the stockholders who originally owned one-half of the stock of American Factors were named as co-defendants in the Hackfeld litigation. There were 615 other stockholders who originally acquired the other one-half of the shares of American Factors. Upon final determination in 1932, that the co-defendants were not guilty of fraud or conspiracy, the benefit to American Factors and to the large number of shareholders owning the other stock of American Factors that accrued by reason of the successful defense of the Hackfeld liti-



gation by the co-defendants, created a liability in American Factors, either in law or in equity, to pay out of the corporate funds preserved in said Hackfeld litigation to these co-defendants the amount they had advanced on account of the Hackfeld litigation expenses.

Further, it is clear that American Factors, having received a great benefit from the services of the co-defendants by their defense in the Hackfeld litigation and their advance collectively of \$396,812.50 of the Hackfeld litigation expense, was bound to reimburse them for these costs under the Doctrine of Restitution. See *Restatement of the Law, Restitution*:

“Sec. 1. UNJUST ENRICHMENT.

“*A person who has been unjustly enriched at the expense of another is required to make restitution to the other.*

‘*Comment:*

“*a.* A person is enriched if he has received a benefit (see Comment *b*). A person is unjustly enriched if the retention of the benefit would be unjust (see Comment *c*). A person obtains restitution when he is restored to the position he formerly occupied either by the return of something which he formerly had or by the receipt of its equivalent in money. . . .

“*b.* *What constitutes a benefit.* . . . He confers a benefit not only where he adds to the property of another, but also where he saves the other from expense or loss. The word ‘benefit,’ therefore, denotes any form of advantage. . . .



“*c. Unjust retention of benefit.* Even where a person has received a benefit from another, he is liable to pay therefor only if the circumstances of its receipt or retention are such that, as between the two persons, it is unjust for him to retain it. . . . The Restatement of this Subject states the rules by which it is determined whether or not it is considered to be just to require restitution.” (pp. 12-13.)

Further, it cannot be said that the co-defendants acted officiously in paying the litigation expenses. *Sec. 2 of Restatement of the Law, Restitution*, is as follows:

“Sec. 2. OFFICIOUS CONFERRING OF A BENEFIT.

“*A person who officiously confers a benefit upon another is not entitled to restitution therefor.*

“*Comment:*

“*a.* Officiousness means interference in the affairs of others not justified by the circumstances under which the interference takes place. Policy ordinarily requires that a person who has conferred a benefit either by way of giving another services or by adding to the value of his land or by paying his debt or even by transferring property to him should not be permitted to require the other to pay therefor, unless the one conferring the benefit had a valid reason for so doing. . . .” (pp. 15-16).

Section 4 deals with the remedy and under (f) it shows that one of the remedies for the recovery of the benefit is by judgment at law or decree in equity for the payment of money.

In *Topic 3*, the subject of restitution deals with discharge by one person of a duty also owed by another. This is as follows:

“TOPIC 3. DISCHARGE BY ONE PERSON OF DUTY  
ALSO OWED BY ANOTHER.

*“Introductory Note:* This Topic deals primarily with situations in which two or more persons were subject to a contractual, quasi-contractual, or other duty which is discharged in whole or in part by one of them, although the other was subject to a duty of performance either prior to, or together with, the one who discharges it. It also deals with situations where, at the time of the discharge, one of the parties is not subject to the duty, including cases where payment is made in the erroneous belief that such a duty exists.

“The situations dealt with in this Topic include those where there are contractual relations between the parties as well as those where there are no such relations.

“Ordinarily, where, at the request of another, a person performs duties owed by the other, acts for the other, or assumes duties owed primarily by the other, it is upon the implicit assumption that he is to be indemnified by the other for payments properly made by him in the course of the transaction. Even if the parties do not have in mind the necessity of such indemnity or do not think of it in detail, a duty of indemnity will be imposed upon the other unless there is an agreement to the contrary. So, too, where two persons engage in a common undertaking or where, to the knowledge of both, two persons become sureties for a third,

an agreement for mutual contribution for expenses borne by each will ordinarily be inferred from the circumstances; *unless the parties agree otherwise, such a duty will be imposed upon them as is consistent with what would have been a fair agreement between them had they considered the matter.*<sup>1</sup> . . .

“Likewise, by a breach of duty to another, a person may cause the other to be liable in tort to a third person, as where a servant is negligent, causing both himself and his master to be liable. In such case, if the other pays the damages thereby relieving the tort-feasor from liability, there is a right to restitution which may exceed the amount of benefit derived from the payment, as where expenses of suit are paid.

“. . . Whether or not the duty is based upon a contract or a tort or is quasi-contractual in nature, at common law an action would lie on the common counts for a payment which benefited the person who should have paid in whole or in part, and in practice today the form of remedy does not depend upon an analysis of the basis of restitution, except where recovery is sought for more than the amount of benefit conferred.” (pp. 327-329.)

The principles enunciated in the Restatement of the Law of Agency, although on a different basis, substantiate American Factors' claim in this particular.

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<sup>1</sup>Emphasis supplied.

The law of Agency also furnishes an analogous conclusion. *Williston on Contracts*, Revised Edition, Vol. Four, Section 1026 is as follows:

*“Employee’s right to exoneration, indemnity, and reimbursement.*

*“ . . . It would seem, furthermore, that a servant or agent should be reimbursed for expenses of defending actions by third persons brought because of the agent’s authorized conduct, especially where such actions are unfounded even though not brought in bad faith. For the same reason an agent or employee is entitled to this protection against liability to third persons arising from the performance of the employment.”*

*Restatement of the Law—Agency*, Section 439, is in part as follows:

**“439. WHEN DUTY OF INDEMNITY EXISTS.**

*“Unless otherwise agreed, the principal is subject to a duty to an agent, not barred by the illegality of his conduct, to reimburse him for or to exonerate him from:*

*“(d) expenses of defending actions by third persons brought because of the agent’s authorized conduct, such actions being unfounded but not brought in bad faith; . . .”*

See, also, *Solimine v. Hollander*, 129 N.J. Eq. 264, 19 Atl. (2d) 344, where it is stated:

*“Where directors of corporation successfully defended stockholder’s derivative suit in which an accounting was sought against directors be-*



cause of alleged dereliction of duty, the directors were entitled to indemnification or reimbursement from the corporation for the reasonable necessary expenses and counsel fees incurred by them in defending the suit, . . .”

*New York Dock Co. v. McCollom*, 16 N.Y.S. (2d) 844.

Headnote 1 in this case is as follows:

“1. *Costs.*

“Ordinarily, the successful party in litigation is not reimbursed for his counsel fees or other expenditures, but when a party to a litigation creates, increases, or protects a fund or property for the benefit of a class, he is ordinarily entitled to have his lawyers compensated and similar expenses paid from the fund or property.”

This case is direct authority that when a party to litigation undergoes the expense to protect a fund or property which results in a benefit to all, he is ordinarily entitled to have his legal expenses paid from the fund or property. This case and foregoing authorities are direct authorities to the effect that had American Factors been sued for reimbursement of litigation expenses advanced by the co-defendants, the courts must give them a judgment for the full amount of their payments.

The court found that the services of the steering committee and the co-defendants were of great value to American Factors in the successful defense of the



Hackfeld litigation and were of a nature which American Factors could not otherwise have furnished for itself (R. 63). This finding would seem to establish the legal right of the co-defendants to restitution for the costs of the litigation which they furnished, even if these costs had been paid voluntarily as the court found, and even though there had been no understanding that they would be reimbursed if they were cleared of the charges of fraud and conspiracy.

Finally, in any event, the fact that a moral obligation existed to reimburse said co-defendants would be sufficient to sustain the deductibility of the amounts reimbursed to the co-defendants.

In *Dunn & McCarthy v. Commissioner of Internal Revenue*, 139 F. (2d) 242, there was in question the deduction of payments made by the corporation as ordinary and necessary expenses. The amounts in question were repaid to salesmen of the company for loans made to the president of the company who had committed suicide and whose estate was insolvent. The purpose was to protect the good will of the business. The court held that there was no legal obligation to repay said loans, but the moral obligation was recognized. The salesmen, in lending money, were undoubtedly influenced by the official position of the president. The failure of the corporation to recognize the loans would impair the attitude of the salesmen as well as affect customers adversely. Accordingly, such payments were held to be ordinary and necessary expenses deductible by the corporation.

Here the reimbursement to the co-defendants of the litigation expenses paid by them, even if founded only upon a moral obligation, would be deductible as ordinary and necessary expenses by American Factors.

It is respectfully submitted that on the foregoing authorities, upon the conclusion of the Hackfeld litigation in the calendar year 1932, American Factors became and was liable for the first time to pay all of the expenses of the Hackfeld litigation. That such payment was an ordinary and necessary expense of the business and deductible as such in that year.

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## II.

**THE COURT ERRED IN DISALLOWING AMERICAN FACTORS THE DEDUCTION OF THE PAYMENT OF \$50,000.00 TO WATERHOUSE COMPANY IN 1931 IN COMPUTING ITS TAXABLE NET INCOME FOR THE CALENDAR YEAR 1932.**

The note of Waterhouse Company (Ex. J, R. 410), evidencing a payment by American Factors of \$50,000.00 in 1931, which American Factors ascertained to have become uncollectible in 1932 (R. 468-470) and which it charged off in that year and deducted as a bad debt loss in computing its taxable net income for the calendar year 1932 (R. 394-395), was given to American Factors under the following circumstances:

Waterhouse Company, which was incorporated as a trust company, found itself short of liquid capital and, in October, 1930, increased its capital stock from

\$200,000.00 to \$400,000.00 by the sale of additional stock to the old stockholders for cash (R. 376-377). Within a month thereafter it became apparent that the general business depression was being felt in the Territory, and the officers were concerned as to whether the company's financial condition was sufficiently liquid to enable it to meet its cash requirements. As a result of discussions among the officers and directors of the company, negotiations were entered into with Bishop Trust Company, Limited, for the sale to it of the stock of Waterhouse Company (R. 377). A detailed examination and appraisal was made of the assets and liabilities of Waterhouse Company (R. 377-379, 488-492, 499-500, 502-505), as a result of which a plan was agreed upon under which two officers, who were large debtors of the company, were to settle their indebtedness to Waterhouse Company, and certain corporations and individuals were to lend various sums to make up a fund aggregating \$400,000.00 (R. 379-382). Upon these conditions being met, Bishop Trust Company, Limited, agreed to take over the stock and operate the business of Waterhouse Company, to liquidate its assets and liabilities, and to return any excess of assets over liabilities to the contributors to said fund after reimbursing itself for any additional amounts that it might be required to advance (R. 377-384, 402-409).

American Factors advanced the sum of \$50,000.00 to said fund and received a note (Ex. J; R. 410), under the terms of which Waterhouse Company agreed to repay the amount thereof with interest at

the rate of 4% per annum, but only when, if and to the extent that there were funds available therefor, in accordance with the plan agreed upon (R. 382-385).

The evidence clearly shows that at the time that the notes were given by Waterhouse Company, the estimated losses, based on an appraisal of individual assets, which leaned toward setting up as large a reserve as possible, were approximately \$260,000.00 less than the reserve actually set up (R. 496-498). In other words, after an appraisal was made and specific reserves set up for each item, there still remained an excess of assets over liabilities of approximately \$260,000.00 in addition to the \$400,000.00 fund set up, and, if the assets had been liquidated at their appraised value on that date (February 14, 1931) the note-holders would have been paid in full (R. 496-498, 554). Thereafter conditions in the community took a turn for the worse and, by the end of 1932, it became apparent to American Factors that by reason of the further reduction in the value of the assets out of which the notes were to be paid, the note held by it was valueless and it was charged off as a loss on its books (R. 413-414, 468, 514, 543). Accordingly, in the computation of its taxable net income for the calendar year 1932, American Factors deducted said sum of \$50,000.00 as a bad debt (R. 394-395).

The judgment of the court denied the deduction of said amount as either a bad debt or as a loss sustained, pursuant to its opinion and findings of fact and conclusions of law.



The relevant portion of the opinion relating to the issue of the deductibility of the Waterhouse Company loan is as follows:

“(2) In 1931 this taxpayer advanced the sum of \$50,000 to H. Waterhouse Trust Company, Ltd. in the hope of aiding, with the help of others, the trust company from closing its doors due to its insolvent condition, which insolvency was known to the taxpayer. The following year the loan was written off the taxpayer’s books as a total loss and deducted as a bad debt in its gross income tax return for that year. It claimed that the loan, while somewhat speculative, was made in good faith and supported by a promissory note. The note contained a proviso, as follows:

“ ‘Payment of principal and interest to be made only when, if and to the extent that there shall be funds available therefor as set forth in letter of this date from the payor to the payee.’

“ ‘This deduction claim is disallowed.’ (R. 60-61).

The findings of fact relevant to this issue are those numbered XVIII to XXIX. With the exception of Finding of Fact No. XXVIII, all the others set forth facts which were stipulated by the parties (R. 79-97).

Finding of Fact No. XXVIII, which is a conclusion of law rather than a finding of fact and with which issue is taken reads as follows:

“The note given by the Henry Waterhouse Trust Company to American Factors, Limited, in acknowledgment of the contribution of \$50,000 made by that company in 1931 to the Henry



Waterhouse Trust Company was contingent as to payment, being subject to such conditions as to render it non-negotiable at the time it was made and at all times thereafter, and without negotiable value from the time it was made. The considerations in payment for the contribution flowed to the payee at the time it was made—the protection of the commercial community, sympathy toward the Henry Waterhouse Trust Company clients who could ill afford to lose, and other commendable desires and motives of helpfulness and security, but there was no attempt to show and there is no evidence of record which would support a finding of fact that American Factors, Limited, would have suffered any loss had it not attempted to keep the Henry Waterhouse Trust Company a going concern.” (R. 96).

The conclusions of law relating to this issue are numbered V and VI, and read as follows:

“V.

“The payment of \$50,000 made to the Henry Waterhouse Trust Company in 1931 by plaintiff was just a contribution. The note given by the Henry Waterhouse Trust Company in 1931 to plaintiff in acknowledgment of that contribution was contingent as to payment, being subject to such conditions as to render it non-negotiable and without any negotiable value at the time it was made and at all times thereafter, and therefore it could not be dealt with as a debt, and the Commissioner of Internal Revenue did not err in disallowing plaintiff a deduction therefor as a bad

debt in computing plaintiff's taxable net income for the calendar year 1932." (R. 102-103).

## “VI.

“No part of this contribution of \$50,000.00 was deductible as a bad debt, ascertained to be worthless and charged off within the taxable year 1932 within the terms of Section 23(j) of the Revenue Act of 1932 or as a loss sustained during that taxable year not compensated for by insurance or otherwise, within the terms of Section 23(f) of the Revenue Act of 1932, and accordingly no part of said contribution was properly allowable as a deduction in computing plaintiff's taxable net income for the calendar year 1932.” (R. 103).

The conclusions of the court, set forth in its opinion, the findings of fact and the conclusions of law, relating to this issue can be summarized as follows:

*First:* That the payment of the \$50,000.00 to Henry Waterhouse Trust Company was just a contribution. (Conclusion of Law No. V, R. 102);

*Second:* That the note in acknowledgment therefor was contingent as to value; that it contained conditions which gave it no negotiable value. (Finding of Fact No. XXVIII, R. 96);

*Third:* That the consideration for the note was the protection of the commercial community, sympathy towards clients of Henry Waterhouse Trust Company, and other commendable desires and motives for helpfulness and security. (Finding of Fact No. XXVIII, R. 96);

*Fourth:* That there is no evidence, nor was there any attempt to show that American Factors would suffer a business loss if Henry Waterhouse Trust was not kept a going concern. (Finding of Fact No. XXVIII, R. 96); and

*Fifth:* That there never was a collectible debt, but merely a contingent or speculative gift, even though it may have accomplished the purpose for which it was intended, namely, extending the life of Henry Waterhouse Trust (Conclusion No. V, R. 102-103).

(A) The sum of \$50,000.00, representing the amount paid to Waterhouse Company in 1931, was deductible as a bad debt, determined to be worthless, and charged off within the tax year 1932.

*Section 23 of the Revenue Act of 1932* pertaining to the deduction of bad debts is as follows:

“(j) *Bad Debts.*—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.”

The evidence is clear and undisputable that American Factors did not intend to make a gift or a contribution to Waterhouse Company. Findings of Fact Nos. XVIII to XXVII, inclusive, which are based almost entirely upon the stipulation of facts of the parties, make clear that Finding of Fact No. XXVIII, which in truth and in fact is a conclusion of law at-

tempting to interpret the preceding findings of fact, is not justified by the facts therein set forth, nor by the evidence in the case.

The very fact that so elaborate an agreement was drawn up, under which Bishop Trust Company, Limited, was required to keep separate records of the assets of Waterhouse Company and to make accountings to the noteholders (R. 87-88), that there was an advisory committee representing the noteholders who met constantly with the officers of Waterhouse Company and consulted and advised with them in connection with the liquidation of the assets, the settlement of claims, and other matters relating to the property of Waterhouse Company (R. 388-390), indicates very strongly that there was a reasonable expectation of getting some return on their notes.

Finding of Fact No. XXI sets forth that under the plan proposed and adopted, the assets and liabilities of Waterhouse Company were to be liquidated and any excess of assets over liabilities, after the reimbursement of Bishop Trust Company, Limited, for additional amounts that it might be required to advance, was to be returned pro rata to those who had advanced moneys to the \$400,000.00 fund together with interest (R. 81-84).

Finding of Fact No. XXIV sets forth an outline of the plan in letters, which were sent to each of the noteholders, setting forth the conditions under which the amounts paid in were to be returned to them. There is also set out that an advisory committee of



the noteholders was set up to pass on matters of importance relating particularly to the amount of reimbursement ultimately to go to the noteholders, the matter of sales of stocks and bonds of Waterhouse Company, and the compromise of claims by and against said company (R. 84-90).

Finding of Fact No. XXVI sets forth that the auditor's report showed that the assets exceeded the liabilities by \$680,000.00, which was set up as a contingent reserve for losses; that that amount included a cushion of \$260,000.00, representing an amount placed in the loss column on schedules prepared covering the individual receivables on the books, which amount was placed in the special contingent reserve after Bishop Trust Company, Limited determined to pay nothing for the stock, so that the assets and liabilities, including the reserves, would balance and the books would show that Bishop Trust Company, Limited should pay nothing for the stock (R. 91-94).

The evidence of Sherwood Lowrey, then treasurer of American Factors, is to the effect that American Factors believed that the note would be repaid (R. 474); that the note was reviewed at the end of 1931, together with all other receivables, and that at that time it was considered good (R. 466-467).

The evidence of E. J. Greaney, independent C.P.A., is that he was consulted with respect to Waterhouse Company, whose assets were deemed to be frozen, and he was asked to evaluate the assets as of January 31, 1931 (R. 487-490); that he computed the expected



losses (R. 495) and, after preparing schedules covering every individual receivable, the sum of \$260,000.00, as a cushion, was added to take care of losses over and above the amount shown on the schedule (R. 497-498); that his work was done in conjunction with officers of Bishop Trust Company, Limited, who were severe in their views of collectibility and whose judgment was no doubt influenced by the fact that they tried to make the losses appear as great as possible (R. 489-490, 499-500). It was the opinion of Mr. Greaney that Waterhouse Company was not insolvent, since the value of its assets exceeded its liability (R. 505-506).

Mr. A. L. Castle, who represented his father who was one of those who contributed to the loan to Waterhouse Company, testified that there was no doubt of repayment of the notes (R. 511); that he served on the advisory committee and that the committee constantly examined the various accounts of Waterhouse Company with Mr. W. A. White, one of the officers of Waterhouse Company, who was in charge of the liquidation, and followed closely with him the liquidation of its assets from time to time (R. 512-513).

Mr. Arthur L. Dean, then a director of Alexander & Baldwin, Ltd., which was another of the lenders, testified that while the loan was possibly not a good investment type, there were other considerations in making the loan, and that it was expected that all or a part of the amount would be returned; that although it was known that a risk was being taken, he expected to get money back on the loan (R. 532-533).

The report of the Bank Examiner of the Territory of Hawaii states that after the company was taken over by Bishop Trust on February 14, 1931, it had sufficient assets on hand to meet all liabilities (R. 554).

There is nothing in the record to justify the conclusion of law that the \$50,000.00, paid by American Factors to Waterhouse Company in 1931, was just a contribution. Likewise, there is nothing in the record to sustain a finding of fact or conclusion that the note was either contingent as to value or that conditions attached to it gave it no negotiable value. The evidence, as pointed out above, was that the persons who knew most about the transaction considered that while some risk was taken in the loaning of the money, and while it may not have been a good investment risk, nevertheless all expected repayment. While it is true that the fact that a note is only repayable out of a particular fund may diminish its value, nevertheless there is nothing in the record that would indicate that this particular note had no value. On the contrary, the record shows that the persons involved believed it to have a value.

In the case of the *Clay Drilling Co. of Texas v. Commissioner of Internal Revenue*, 6 T.C. 324, there was in question the deductibility of bad debt losses. The amounts charged off as bad debts were amounts that were admittedly owed to the taxpayer originally. However, an agreement was thereafter entered into under which the taxpayer agreed to pay certain commissions to the debtors and apply a certain portion

of the commissions payable to the liquidation of the indebtedness. The agreement further provided that the taxpayer would recover said indebtedness only in this manner, and that the debtors would not be personally liable for the payment of the debts except out of the share of the commissions which accrued.

The Commissioner contended that the accounts did not represent debts which were due taxpayer at the time they were charged off. He does not dispute that the accounts, when originally incurred, did represent debts, but contends that by the contract the indebtedness was cancelled and forgiven and no longer existed as a debt. The basis for the contention was that the contract in question provided a method of payment to the corporation of the indebtedness by means of commissions on certain drilling contracts, and the contract provided that the indebtedness was payable only out of the commissions and was not to be construed as a money or personal obligation payable by the debtors. The Commissioner claimed that in agreeing that the accounts were not to be construed to be a personal obligation they ceased to be debts.

The court said that if that is true, the Commissioner should prevail because the taxpayer would then have no debts to become worthless in the taxable year and, therefore, nothing to deduct. The court, however, found that those debts were not cancelled or forgiven by the terms of the contract; that the debts continued to exist, but payable only in the manner agreed upon, and the court stated, on page 331:

“It seems to us that the debts of the Herschbachs to petitioner continued to exist, payable, it is true, only in the manner agreed upon. We know of no law which is to the effect that a debt is canceled and forgiven merely because the manner of its payment is restricted and it is agreed that the debtor shall not be personally liable if the debt is not fully paid in that manner. Both parties concede that they know of no case exactly in point. Our search has not disclosed any. In *Riverview State Bank*, 1 T.C. 1147, we held, following several circuit court decisions cited in our report, that interest on special tax bills issued by the city of Kansas City, Kansas, which was levied and assessed by the city as a tax and was payable to the holders of the tax bills by the city, but was not payable out of the general funds of the city, was tax exempt as interest upon the obligations of a political subdivision of the state. In that case it was the Commissioner’s contention that, since no obligation for payment of either principal or interest on the tax bills rested directly upon the city, they were not ‘obligations’ of the city within the meaning of the statute. We held against such contention. Of course the question we have here to decide is entirely different from the question which was present in the *Riverview State Bank* case, and yet we think the underlying reasoning in that case is of some help here. In some earlier cases involving the same question of exemption from taxation which we had in the *Riverview State Bank* case we had held that the bonds were not exempt because they were payable only out of special taxes and not unconditionally payable by the municipality—therefore, were not ‘obligations’ of the municipality within the mean-



ing of the applicable statute. We were reversed in some of these cases, the Circuit Court of Appeals holding that the bonds were 'obligations' of the municipalities even though payable only out of special tax bills and in no other manner. . . .

"Along somewhat the same line of reasoning, we think it is reasonable to hold that these accounts due by the Herschbachs to petitioner *continued to be debts or obligations owed by the Herschbachs to petitioner, even though payable only in a special way and not out of the debtor's 'general funds,' so to speak. . . .*"<sup>1</sup>

The same would be applicable to the present case. The mere fact that the notes were payable in a special way would not prevent the notes from constituting debts of the Waterhouse Company which could be the proper subject of a tax deduction at the time they were determined to be worthless.

In *Western Woodwork & Lumber Co. v. Commissioner*, 6 T.C.M. 504, taxpayer's president owned a lot and proposed to a building contractor that he build a house on the lot and, when the house was sold, taxpayer's president would be reimbursed in an agreed amount for the lot. The builder agreed to this if the taxpayer would furnish the lumber and mill work and if the builder's liability to pay would be limited to paying taxpayer said amount from the proceeds of the sale of the house when made. This agreement was accepted by taxpayer. In 1929 taxpayer received a note from the builder bearing interest, but it was

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<sup>1</sup>Emphasis supplied.



agreed that he would not be liable on the note except to pay the same out of funds received from the sale of the house. The builder tried to sell the property, but failed to do so until January, 1943. In 1935 the builder had informed the taxpayer that he was ready to disclaim all hope of profit in the house, and offered to deed the same to taxpayer free of any claim. The taxpayer rejected this offer because he considered that the house with a mortgage on it was a liability. The taxpayer claimed the loss in 1943 when the house was sold and it received only a small payment out of the proceeds. This claim was disallowed by the Commissioner. The Tax Court upheld the Commissioner's determination, but not on the grounds that no debtor-creditor relationship existed because taxpayer had only a contingent claim as contended by the Commissioner, but because the worthlessness of the bad debt was established in 1935.

Here again is a case where the contingency that the fund from which the note was payable might prove insufficient to enable the payment to be made did not deprive the note of its character as a debt subject to being charged off and deducted as a bad debt when it became worthless.

It must be self-evident that the mere fact that the note was not negotiable does not necessarily mean that it had no value and no further point need be made of any implications that may arise from the court's characterization of the note as having no negotiable value. So long as there remains a reasonable expectation of repayment of a note, the note has value

whether it is negotiable or merely transferable by assignment.

With regard to the consideration for the making of the loan as set forth by the court, namely, the protection of the commercial community, sympathy towards clients of Waterhouse Company, and other commendable desires and motives for helpfulness and security, it is quite apparent that this finding or conclusion would be immaterial in determining the deductibility of the loan. It is well settled that the motives for advancing money or for lending money are not important in determining whether a payment is or is not a loan which can be the subject of a tax deduction as a bad debt. *Cooper-Brannan Naval Stores Co. v. Commissioner of Internal Revenue*, 9 B.T.A. 105, 108.

It is also clear that it is not the province of the court to inquire into the wisdom of the loan. It is only necessary for the taxpayer to establish the fact that the amounts advanced were ascertained to be worthless and charged off within the taxable year. *Holmes Ives v. Commissioner of Internal Revenue*, 5 B.T.A. 934, 936, and *Roy Nichols v. Commissioner of Internal Revenue*, 17 B.T.A. 580, 584, in which latter case it was held that a debt was deductible even though the financial condition of the debtor was known by petitioner to be precarious at the time the loan was made and so remained at all times thereafter, but the court said that the money was loaned under a promise to repay and that it was not a gift.

The evidence, as summarized above, indicates clearly that all the parties believed that the note in question represented a collectible debt, despite the so-called finding of the court to the contrary. The evidence conclusively shows that the payment of \$50,000.00 to Waterhouse Company was not a contribution or gift, and that it was undoubtedly deemed to be collectible, and there is nothing in the record that would indicate otherwise nor is there anything in the record to indicate that there was not a reasonable expectancy that the assets would be sufficient to permit the repayment of a part, if not all, of the amounts represented by the notes. Further, the mere fact that the note was not negotiable, or that it contained conditions which limited its payment out of a particular fund, would not deprive the note of its character of representing a debt or obligation of the company which could be the proper basis of a deduction as a bad debt.

The only question is whether in truth and in fact a loan was made which constituted a debt on the part of the borrower and which could be the subject of a bad debt loss deduction. The evidence shows conclusively that it was such a loan, and the deduction as a bad debt should be allowed at the time said note became worthless.

That the note was ascertained to have become worthless in 1932 and was charged off as a bad debt in that year, is amply justified by the evidence.

Sherwood Lowrey, treasurer of American Factors, testified that in accordance with their usual procedure,

all the receivables were reviewed each year; that at the end of 1932, after a full examination of the matter and a discussion with various people who were familiar with the matter, the conclusion was reached that the note was valueless and it was charged off the books (R. 466-471).

Carl Linden, who was tax advisor and advisor in connection with accounting procedure of both American Factors and Alexander & Baldwin, another of the noteholders (R. 540-541), testified that after examination and discussion with various persons, the conclusion was reached that there was no possibility of recovery on the note (R. 543).

The bank examiner's report of the condition of Waterhouse Company at the close of business December 31, 1932, contained the statement, "An analysis of the various asset and liability accounts of the company made by us as at December 31, 1932, disclosed according to our figures, an insufficient amount of assets to meet the remaining liabilities." (R. 554).

Alfred L. Castle testified that a restudy was made of the assets of Waterhouse Company in 1932; that a letter (Ex. M, R. 413) was sent to each of the noteholders advising them that a reappraisal disclosed that its liabilities exceeded the value of its assets by a very considerable amount, which statement, Mr. Castle testified, was true so far as could be ascertained, and that he had come to the conclusion, as a result of his study, that the note was worthless and should be written off (R. 512-515).



It is, therefore, respectfully submitted that the note became worthless in 1932; was properly ascertained by American Factors to have become worthless after reasonable investigation and study; that the note was charged off as a bad debt in that year and that this deduction is a proper one and should be allowed in the computation of the income tax liability of American Factors for the calendar year 1932.

- (B) If not deductible as a bad debt, the sum of \$50,000.00, representing the amount paid to Waterhouse Company in 1931, was deductible as a loss sustained, or as an ordinary and necessary expense of American Factors in 1932.

*Section 23 of the Revenue Act of 1932* providing for the deduction of losses by corporation is as follows:

“(f) *Losses by Corporations.*—Subject to the limitations provided in subsection (r) of this section, in the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.”

*Section 23 of said Revenue Act* providing for the deduction of ordinary and necessary expenses is as follows:

“(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . . .”

In denying the alternative claim of American Factors that the deduction of \$50,000.00 should be allowed as a loss or an ordinary and necessary expense of do-



ing business if it were not allowable as a bad debt, the only finding of the court or statement in the opinion was to the effect that there was no evidence or attempt to show that American Factors would suffer a business loss if Waterhouse Company were not kept a going concern (R. 96). This conclusion is likewise at odds with the record in the case.

Sherwood Lowrey testified that it was the opinion of the business interests in the community that it might be disastrous to the community as a whole if the Waterhouse Company failed (R. 465) and, again, that various ones involved concluded that it was to the best interest of the community and, therefore to American Factors, that Waterhouse Company be assisted by the loan (R. 474).

Mr. Dean testified that one of the purposes of the loan was to maintain the integrity and stability of the basic business enterprises of the Territory; that this was a small, isolated and closely-knit community; that it was felt it would be a major disaster, the ramifications of which could not be foreseen, if one of the trust companies was unable to meet its obligations (R. 527).

Further, the evidence in the record specifically set forth in Finding of Fact No. I (R. 67) showing the large stake of American Factors in the business of the Territory, would make it apparent that the failure of Waterhouse Company could not help but adversely affect the business interests of American Factors, as well as other businesses in the Territory.

In *Robert Gaylord, Inc. v. Commissioner of Internal Revenue*, 41 B.T.A. 1119, 1127, the petitioner was a Missouri corporation engaged in the business of manufacturing, selling and shipping containers, with its principal office in St. Louis, Missouri, where a large portion of its business was done. In 1931, one of the four leading banks in St. Louis experienced a silent run, during which withdrawals of approximately a million dollars a day in excess of deposits were being made. At that time the banking situation in St. Louis was acute, many depositors were worried over the safety of their deposits, and runs on banks were frequent. The Finance Commissioner of Missouri, after an examination of its affairs, found that the bank would probably be unable to pay its current liabilities and informed the officers of the bank and the members of the St. Louis Clearing House Association that unless it could be merged or consolidated with some other bank in St. Louis, he must order it closed and appoint a receiver to liquidate it. In order to avoid the serious financial crisis which would result from the closing of the bank and the appointment of a receiver, another bank was urged to take over the assets and assume its liabilities. That bank agreed that if it were furnished a guarantee against loss in an amount aggregating \$2,000,000.00, it would take over the assets and assume the liabilities. The member banks of the St. Louis Clearing House Association agreed to participate in the guarantee fund up to \$1,250,000.00. The officers and representatives of other businesses in St. Louis, including the petitioner, were called together, informed

of the situation and the terms under which the other bank would be willing to assume the liabilities of the distressed bank, and were informed that the general banking situation was getting acute; that if the bank were allowed to fail it would seriously affect all business, industry and banking in the city; that failure of the bank would result in a general run on the various banks in the city and, possibly, the failure of some of them; that while the bank was requiring a guarantee of \$2,000,000.00, it was believed that the loss to be sustained would be covered by the capital and there probably would be no occasion to require payment by those who subscribed to the guarantee fund.

The petitioner subscribed \$15,000.00—deposited that amount and received a certificate of deposit in 1932. In 1936 petitioner was informed that appraisals of the remaining unliquidated assets showed that such assets would be insufficient to satisfy the liabilities of the bank that had been taken over. On the basis of the appraisal, petitioner surrendered its certificate of deposit in order to prevent the necessity of actually selling the remaining unliquidated assets which might involve further losses on quick liquidation.

The Commissioner contended that the petitioner had merely made a voluntary contribution; that it participated in a rescue party purely as a matter of civic pride; that the amount was not paid as an ordinary or necessary expense of carrying on its trade or business.

The court said (p. 1122) that petitioner's argument in connection with its claim that the amount is de-

ductible as a loss, a contribution, or a debt ascertained to be worthless, is not without substantial merit. However, the court stated its opinion that the issue may be determined by ascertaining whether or not the expenditure constituted an ordinary and necessary business expense.

The testimony of the president of petitioner as to why it signed the agreement was that the businessmen were trying to save the situation; that there were rumors going around and that the company had quite an equity in the picture there; that there were accounts receivable, bank balances, and that he felt that the closing of the bank would adversely affect his business.

The court went on to say that the expenditure in question was deemed by the taxpayer to be necessary for the protection of its own business. The effect of the failure of the bank upon petitioner's business might well have been considerable.

The court further went on to say that banks and financial institutions were dependent, first, upon their own assets, and secondly, upon such assistance as they might receive in times of stress from their officers, directors and stockholders, from other banks, and from corporations and individuals who came to their rescue either as a gesture of friendship or, more frequently, as a matter of self defense. The plan devised and followed by the banks and business men of St. Louis, or some modification or variation of it, was being carried out in many sections of the country.



Accordingly, it held that the amount in question was deductible as an ordinary and necessary expense of carrying on petitioner's trade or business.

To the same effect is *Moloney Electric Co. v. Commissioner of Internal Revenue*, 42 B.T.A. 78, involving another guarantor to the payment fund involved in the *Gaylord* case, *supra*. The court held that the same conclusion must be reached as in the *Gaylord* case. Although the evidence was not as extended as the evidence in the *Gaylord* case, the court was of the opinion that judicial notice may be taken of the fact that the period was a very critical one in the banking situation generally; that, as stated in the *Gaylord* case, bank failures in 1931 were twice as numerous as they had been during the preceding year; four times as numerous as during the year 1929, and six times as numerous as during the average year in the predepression era; that the expenditure of the relatively small amount of money by the petitioner under the circumstances disclosed, supplemented by the matters as to which the court took judicial notice, constituted an ordinary and necessary expense of carrying on its trade or business.

To the same effect is *First National Bank of Skowhegan v. Commissioner of Internal Revenue*, 35 B.T.A. 876.

That financial institutions were in a precarious condition in 1931 is a well known fact of which the court can take judicial notice. That an organization together with the companies for which it acted as agent had



almost two million dollars on deposit in banks of the Territory, which carried on many businesses which had a capital and surplus of about \$16,000,000 and was agent for other businesses having an aggregate capital and surplus of more than \$48,000,000.00 (R. 375-376), would suffer a great loss if there should be a serious upset in the financial conditions in the small, closely-knit community in which it did business, would seem to be self-evident.

It is respectfully submitted that from the known facts of business conditions at the time, the cases here cited, and the facts set forth in *Bishop Trust Company, Limited v. Commissioner of Internal Revenue*, 36 B.T.A. 1173, and *Bishop Trust Company, Limited v. Commissioner of Internal Revenue*, 47 B.T.A. 737, with reference to the loan here in question, the conclusion is inescapable that if the loan of \$50,000.00 to Waterhouse Company is not deductible as a bad debt in 1932, it is deductible as an ordinary and necessary expense of doing business of American Factors in that year.

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### CONCLUSION.

It is therefore respectfully submitted that American Factors is entitled to the deduction of the amount of \$396,812.50, of Hackfeld litigation expenses reimbursed to the co-defendants, as an ordinary and necessary expense in computing its taxable net income for the calendar year 1932, and that American Factors is entitled to deduct the amount of \$50,000.00, advanced

to Waterhouse Company, which became uncollectible in 1932, as a bad debt, as a loss sustained in that year, or as an ordinary and necessary expense of doing business in that year.

Dated, Honolulu, T. H.,  
March 17, 1950.

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In the United States Court of Appeals  
for the Ninth Circuit

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AGNES M. KANNE, EXECUTRIX UNDER THE WILL AND  
OF THE ESTATE OF FRED H. KANNE, COLLECTOR OF  
INTERNAL REVENUE OF THE UNITED STATES FOR THE  
DISTRICT OF HAWAII, APPELLANT

v.

AMERICAN FACTORS, LIMITED, AN HAWAIIAN CORPORA-  
TION, APPELLEE

---

AMERICAN FACTORS, LIMITED, AN HAWAIIAN CORPORA-  
TION, APPELLANT

v.

AGNES M. KANNE, EXECUTRIX UNDER THE WILL AND OF  
THE ESTATE OF FRED H. KANNE, COLLECTOR OF IN-  
TERNAL REVENUE OF THE UNITED STATES FOR THE  
DISTRICT OF HAWAII, APPELLEE

---

ON APPEALS FROM THE UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF HAWAII

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BRIEF FOR AGNES M. KANNE

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**In the United States Court of Appeals  
for the Ninth Circuit**

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No. 12391

AGNES M. KANNE, EXECUTRIX UNDER THE WILL AND  
OF THE ESTATE OF FRED H. KANNE, COLLECTOR OF  
INTERNAL REVENUE OF THE UNITED STATES FOR THE  
DISTRICT OF HAWAII, APPELLANT

*v.*

AMERICAN FACTORS, LIMITED, AN HAWAIIAN CORPORA-  
TION, APPELLEE

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AMERICAN FACTORS, LIMITED, AN HAWAIIAN CORPORA-  
TION, APPELLANT

*v.*

AGNES M. KANNE, EXECUTRIX UNDER THE WILL AND OF  
THE ESTATE OF FRED H. KANNE, COLLECTOR OF IN-  
TERNAL REVENUE OF THE UNITED STATES FOR THE  
DISTRICT OF HAWAII, APPELLEE

---

*ON APPEALS FROM THE UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF HAWAII*

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**BRIEF FOR AGNES M. KANNE**

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OPINION BELOW

The opinion of the District Court (R. 59-66) is re-  
ported in 76 F. Supp. 133.

## JURISDICTION

This appeal involves federal income tax for the year 1932. The tax in dispute was paid as follows: \$62,438.82 on December 30, 1937, and \$12,657.68 on October 26, 1938. (R. 14-16.) A claim for refund covering the tax paid December 30, 1937, was filed on April 5, 1938, and rejected by notice dated December 2, 1938. (R. 15.) By letter dated June 29, 1938, the Commissioner of Internal Revenue determined an additional deficiency in tax of \$12,657.68 which was paid as stated above on October 26, 1938, and on December 22, 1938, a second claim for refund of the additional tax and interest collected thereon was filed, but no action was taken on this second refund claim and more than six months had elapsed since the filing of this claim when this suit was instituted. (R. 15-16.)

Within the time provided in Section 3772 of the Internal Revenue Code and on January 6, 1940, the taxpayer brought an action in the District Court for the Territory of Hawaii for recovery of the taxes paid. (R. 2-17.) Jurisdiction was conferred on the District Court by the Act of April 30, 1900, c. 339, 31 Stat. 141, Section 86, as amended. Judgment was entered on June 15, 1949. (R. 104-106.) Within sixty days and on August 4, 1949, a notice of appeal was filed by the Collector,<sup>1</sup> and on August 15, 1949, the taxpayer filed a notice of appeal. (R. 107-109.) Jurisdiction is conferred on this Court by 28 U. S. C., Section 1291.

## QUESTIONS PRESENTED

*Raised by Collector's appeal:*

1. Whether certain litigation expenses in the amount of \$83,802.76, which were paid by taxpayer in years

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<sup>1</sup> The Collector herein now dead, his executrix, Agnes M. Kanne, was substituted as defendant in the court below. Throughout this brief we are using the term Collector for convenience and brevity.



prior to 1932, accrued prior to 1932 with the consequence that the expenses may not be deducted in 1932 by taxpayer, which reports on the accrual basis of accounting.

2. Whether litigation expenses in the amount of \$87,-992.50, paid in 1932, accrued prior to that year, with the result that they are not properly deductible in 1932 by the taxpayer on the accrual basis of accounting.

*Raised by taxpayer's appeal:*

3. Whether taxpayer was legally obligated to reimburse certain of its stockholders for litigation expenses of \$396,812.50 contributed by the stockholders in defending a suit in which taxpayer and they were codefendants, with the consequence that taxpayer may deduct in 1932 the distribution of \$396,812.50 to such stockholders in that year.

4. Whether a payment of \$50,000 in 1931 to a trust company for the purpose of preventing its financial collapse was merely a contribution rather than creating an indebtedness of a kind which may be deducted in 1932 under Section 23 (j) of the Revenue Act of 1932 as a bad debt ascertained to be worthless and charged off.

5. Alternatively, whether the \$50,000 payment may be deducted as an ordinary and necessary business expense in 1932 under Section 23 (a) of the Revenue Act of 1932 or as a loss sustained in 1932 under Section 23 (f) of the Act.

#### STATUTES AND REGULATIONS INVOLVED

The applicable statutes and Regulations are printed in the Appendix, *infra*.

#### STATEMENT

This case comes to this Court on cross appeals from a judgment partially in favor of the taxpayer in an

action below to recover income tax in the amount of \$97,134.90, with interest for the calendar year 1932.

The material facts as found by the District Court (R. 67-100), may be summarized as follows:

*Facts relating to litigation expenses.*

The controlling capital stock of H. Hackfeld & Company (hereinafter referred to as "Hackfeld"), a Hawaiian corporation engaged principally in the sugar agency and factor business, was owned by German interests. In March, 1918, this stock was seized by the United States Alien Property Custodian. A plan of reorganization was formed, as a result of which the taxpayer, American Factors, Limited, was organized to take over the business and assets of Hackfeld. The stock (trust certificates) of taxpayer under the plan was to be sold to American citizens engaged in or familiar with the sugar agency business in Hawaii. Pursuant to the plan trust certificates representing 50,000 shares of taxpayer's stock were sold for a total price of \$7,500,000, which was paid to Hackfeld in exchange for all its assets and business. Persons who were the incorporators of taxpayer and who subsequently became its officers and directors entered into a joint subscription agreement under which they became the owners of trust certificates for 25,000 shares of taxpayer's stock. (R. 68-70.)

In June, 1924, taxpayer's directors were informed that former stockholders of Hackfeld, then dissolved, were threatening litigation, but it was not known who would be named defendants. Taxpayer's directors authorized employment of counsel to defend it, if it were named as a defendant. On July 28, 1924, 21 of the 23 persons and corporations, who had joined in the joint subscription agreement, agreed in writing to prorate on an original per share basis the expenses of

the threatened litigation, if they were joined as defendants. (R. 70-71.)

In August and September, 1924, identical suits were filed by J. C. Isenburg and others in a Hawaii and a California state court against the Alien Property Custodian, the taxpayer and the 23 persons and corporations who were parties to the joint subscription agreement, as codefendants. Only the California suit was tried. The complaint in that suit alleged *inter alia* that the sale of Hackfeld's assets to taxpayer was fraudulent and at a price far below the true value of the assets, and that the taxpayer had improperly managed Hackfeld's business. It claimed damages in the total amount of \$12,500,000 from all defendants, except the Alien Property Custodian, to be fixed in such manner as the court deemed proper. The attorneys employed by the taxpayer prepared and filed a joint answer on behalf of the taxpayer and the codefendants other than the Alien Property Custodian. (R. 71-74.)

On January 6, 1926, the California court filed a memorandum and on March 16, 1926, a decision, in both of which it found that there was no fraud and that the price paid for the Hackfeld assets was adequate. On January 31, 1927, it entered judgment for the defendants. On April 30, 1931, the Supreme Court of California affirmed the judgment of the trial court and thereafter denied a petition for rehearing and a motion of the plaintiffs. On April 25, 1932, the United States Supreme Court denied certiorari. This terminated the litigation. (R. 75-77.)

The total cost of the Hackfeld litigation was \$568,-607.76 which the taxpayer paid.<sup>2</sup> From time to time (prior to 1932) the taxpayer received from its codefendants their pro rata share of the total expenses

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<sup>2</sup> All of the expenses were paid in years prior to 1932 except for \$87,992.50 paid in 1932. (R. 198.)

paid in the amount of \$396,812.50. In 1932 after the conclusion of the litigation taxpayer repaid to its codefendants the \$396,812.50 advanced by them during the progress of the litigation. Repayment was authorized by taxpayer's directors but was wholly voluntary, was not pursuant to demand of the codefendants, and was not a result of a test of the right of the codefendant stockholders to have contributions at the expense of other shareholders not named as defendants in the litigation. There is no evidence that taxpayer promised or intended to reimburse the codefendants at the time they subscribed or contributed to the litigation expense, or that taxpayer considered the matter until the litigation was concluded in 1932. The approval by taxpayer's stockholders of the reimbursement of the codefendants from the taxpayer's funds apparently flowed largely from gratitude for the successful outcome of the litigation and for the liberal aid of the codefendants in supplying facilities and influences which could not have been supplied by taxpayer alone. (R. 77-78.)

The Hackfeld litigation imperiled taxpayer's existence. Taxpayer had substantial interests to protect and much to lose if the codefendants had not volunteered to fight the battle at their own cost and if taxpayer had not accepted their payment plan and their volunteered services. (R. 79.)

In making the agreement to pay voluntarily their shares of the expenses for defending the litigation, the codefendants were motivated entirely by keen personal desires to clear themselves of charges of unlawful conspiracy and fraud, to escape a judgment against them for damages, and to protect their individual investments as shareholders. They offered to pay, and did pay to the extent of assessments against them; their contributions to the litigation defense fund with-



out promise or expectation of reimbursement. (R. 78-79.)

During the years 1924-1932, inclusive, taxpayer's books were kept, and its tax returns were filed, on the accrual basis of accounting. Over that period it carried the payments totaling \$568,607.76 as deferred items on its records until after conclusion of the litigation in 1932. At that time it charged off on its books the entire amount<sup>3</sup> and took a deduction for the entire amount in computing its net taxable income on its income tax return for 1932. (R. 77, 79, 96.) The Commissioner of Internal Revenue disallowed the entire amount as a deduction. (R. 79.)

The District Court concluded that taxpayer was entitled to deduct in 1932 as an ordinary and necessary business expense under Section 23 (a), Revenue Act of 1932, the amount of \$171,795.26, representing the Hackfeld litigation expenses paid by it. (R. 100-101.) The Collector has appealed.

The District Court further concluded that taxpayer was not legally obliged or liable to repay the amount of \$396,812.50 to its codefendants in the Hackfeld litigation, and that taxpayer is not entitled to deduct the amount in 1932 as an ordinary and necessary business expense under Section 23 (a). (R. 101-102.) The taxpayer has appealed.

*Facts relating to \$50,000 payment claimed as bad debt or loss.*

The Henry Waterhouse Trust Company, Limited (hereinafter referred to as "Waterhouse") was a

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<sup>3</sup> In 1932, \$541,237.79 of these expenses was charged to the taxpayer's general reserve account which was carried over from H. Hackfeld & Company, Limited, and the balance of \$27,369.97 of these litigation expenses was charged against the taxpayer's earned surplus. (R. 289.) No part of these litigation expenses was charged to profit and loss on the taxpayer's books. (R. 295.)



Hawaiian corporation engaged in the trust company business. In 1930 a large part of its assets consisted of real estate and mortgages and its secretary became apprehensive that if many calls were made on its demand accounts, due to the effect of the business depression, its condition was not sufficiently liquid to meet its cash requirements. In 1931 it was conducting business as usual, but was encountering some financial difficulties. The Bishop Trust Company (hereinafter referred to as "Bishop"), which had been considering the purchase of Waterhouse's stock for cash, after investigation, advised in 1931 that it would not pay cash for the shares. A. W. T. Bottomley, president of taxpayer and of a Honolulu bank and vice-president of Bishop, then called a conference of the heads of the principal Hawaiian sugar agencies and banks to present the financial condition of Waterhouse and to discuss plans to prevent Waterhouse's forced litigation. (R. 79-81.)

On February 14, 1931, at a meeting of the directors of Bishop, a plan was presented, largely as a salvage proposition, pursuant to which Bishop would acquire all of Waterhouse's stock without cost and would operate its business for Bishop's own benefit. Cash payments totaling \$1,035,000 were to be made to Waterhouse by Bishop, creditors and others. Included in this total figure was a cash contribution of \$400,000 to be made by a number of corporations and individuals. Waterhouse's assets and liabilities were to be retained by it and were to be liquidated gradually under Bishop's supervision for a fee of \$1,000 per month. Upon final settlement, if any proceeds remained after paying liabilities and expenses, repayment was to be made first to Bishop for any advances made by it in excess of the \$1,035,000 cash, and then pro rata to the contributors of the \$400,000, together with four percent

interest. The objects of the plan were to prevent Waterhouse's failure with its general disastrous effects, to prevent loss on the part of the depositors who could ill afford to lose, and to enable Bishop to acquire new business. The plan as outlined was approved by Bishop's board of directors and the cash payments mentioned were duly made a few days after February 14, 1931. (R. 81-84.)

Prior to that date certain corporations, including taxpayer, and individuals had promised to pay to Waterhouse upon consummation of the proposed plan the total amount of \$400,000. Taxpayer's contribution was \$50,000. The total amount was actually paid to Waterhouse by the corporations, including taxpayer, and individuals as promised by them. For these contributions Waterhouse's notes, bearing interest at four percent, were given, subject to being paid however only after other liabilities and expenses of Waterhouse were paid, as provided in the plan and as outlined by Waterhouse in letters to the contributors. (R. 84-90.) The note for \$50,000 issued to taxpayer by Waterhouse was dated February 21, 1931, and contained the provision that (R. 90):

\* \* \* payment of principal and interest to be made only when, if and to the extent that there shall be funds available therefor as set forth in letter of this date from the payor to the payee.

Taxpayer was not a stockholder of Waterhouse. (R. 90.)

An audit report dated March 31, 1931, listed the book value of Waterhouse's assets as of February 14, 1931, as \$4,820,090.92 and the book value of its liabilities, exclusive of capital and surplus, on that date as \$4,149,437.02. The audit report stated that the reserve for losses of \$680,803.15 and the special contingent reserve

of \$400,000 (for "underwriters" (R. 95)) were considered adequate to cover probable losses in the realization of assets and liquidation of liabilities. At December 31, 1931, Waterhouse had actually sustained on liquidation a loss of \$324,913.77 and at December 31, 1932, a cumulative loss of \$410,345.80, so that at the end of 1932 there remained a balance of \$190,457.35 in the reserve for losses, against which future losses would be charged before there would be an impairment of the special contingent reserve for repaying the \$400,000 contributions to the special noteholders. (R. 91-95.)

The \$50,000 note received by taxpayer was contingent as to payment and subject to such conditions as to render it nonnegotiable at that time and thereafter, and without negotiable value at any time. There is no evidence that taxpayer would have suffered any loss if it had not attempted to keep Waterhouse a going concern. The considerations flowing to taxpayer for its contribution of \$50,000 were the protection of the commercial community, sympathy toward clients of Waterhouse who could not afford to lose, and other commendable desires and motives of helpfulness and security. (R. 96.)

In 1932 taxpayer charged off on its books as a bad debt the \$50,000 note received in 1931. (R. 96-97.)

The District Court concluded that the payment of \$50,000 to Waterhouse in 1931 was only a contribution; that the note given to it in acknowledgment of the contribution was not a debt; and that no part of the \$50,000 was deductible in 1932 as a bad debt ascertained to be worthless and charged off within the terms of Section 23 (j) of the Revenue Act of 1932. The District Court further held that no part of the \$50,000 was deductible as a loss sustained in 1932 under Section 23 (f) of the 1932 Act. (R. 102-103.)

## STATEMENT OF POINTS TO BE URGED BY AGNES M. KANNE

The Collector's statement of points on appeal (R. 618-619), all of which are relied on here, may be summarized as the following point:

The District Court erred in holding that the taxpayer is entitled to deduct in 1932 \$171,795.26 of the Hackfeld litigation expenses as expenses accruing in that year.

## SUMMARY OF ARGUMENT

I. The taxpayer's share of the Hackfeld litigation expenses was \$171,795.26, which the District Court held could be deducted by taxpayer in 1932. This holding is erroneous. No part of the amount was incurred or accrued as an expense in 1932, and Section 43 of the Revenue Act of 1932 therefore forbids any deduction in 1932 by the taxpayer which reports on the accrual basis of accounting.

Of the amount, \$83,802.76 was paid by taxpayer prior to 1932. The liability to pay and the amount thereof must have been fixed when the expenses were paid, and the expenses therefore necessarily had accrued before being paid. In any case, the proof offered requires this conclusion, for the defense at the trial and on appeal was concluded prior to 1932. There was no showing that the amounts paid prior to 1932 were to cover any services performed or expense to be incurred in 1932.

Taxpayer paid \$87,992.50 of its share of the expenses in 1932, but failed to prove, as it was required to do in order to prevail, that any part of these expenses were incurred and accrued in 1932. And the history of the litigation makes it highly doubtful that any of the expenses were incurred in 1932. Taxpayer must fail on this item for lack of proof to establish its accrual and deductibility in 1932.



II. The stockholder-incorporators' share of the Hackfeld litigation expenses was \$396,812.50 which they paid in 1924-1926. The taxpayer reimbursed them for these expenses in 1932. The District Court correctly held that the amount was not deductible in 1932.

The amount was not incurred in carrying on the taxpayer's business, as Section 23 (a), Revenue Act of 1932, requires as one condition for a deduction. It was not a part of the taxpayer's sugar agency and factor business to pay expenses of defending its stockholder-incorporators from charges of fraud and conspiracy occurring before taxpayer's organization and before it engaged in business nor was the payment of expenses of protecting its stockholders' property proximately connected with its business.

Furthermore, the expenses were those of taxpayer's stockholder-incorporators and thus were not ordinary, that is, normal or customary, expenses of taxpayer's business as Section 23 (a) requires to permit a deduction. The taxpayer's payment of the expenses was wholly voluntary and not legally required, as the District Court correctly found.

Finally even assuming *arguendo* that the stockholder-incorporators' share of the expenses might be deducted by taxpayer in the year of accrual, 1932 was not the year in which the expenses accrued. The expenses were incurred and paid by the stockholders from 1924 to 1926, inclusive. Assuming *arguendo* that taxpayer had an obligation, as it emphatically contends, to reimburse the stockholders, that liability existed in 1924-1926 and accrued at that time. Taxpayer cites no authority and offers no convincing argument to support its contention that its obligation to reimburse accrued only when the litigation was finally terminated in 1932.



III. The \$50,000 contributed to the Waterhouse fund in 1931 is not deductible in 1932 as a bad debt ascertained to be worthless and charged off in that year under Section 23 (j), Revenue Act of 1932. The \$50,000 note received by taxpayer from Waterhouse was not payable at all events but its payment was contingent on Waterhouse having funds to pay it after all of its other liabilities and expenses had been paid. Moreover, the \$50,000 was paid by taxpayer as a contribution to serve the community generally and without expectation of repayment. Under the authorities, both of these circumstances require the conclusion that no debt sufficient to support a deduction under Section 23 (j) was created.

Furthermore, assuming *arguendo* only that a valid debt was created, the taxpayer failed to prove facts sufficient to enable the District Court to determine that taxpayer's alleged ascertainment of worthlessness of the debt in 1932 was based on facts warranting that conclusion. Moreover, the record strongly indicates that taxpayer did not deem the "debt" worthless in 1932, assuming *arguendo* that it ever believed the note had value, since it declined to concede its worthlessness for other purposes.

The \$50,000 paid in 1931 is not deductible as a loss sustained in 1932, because a voluntary contribution is not a basis for deducting a loss at any time. Moreover, the loss, if there was one, was not sustained in 1932 and could not be deducted in 1932 under Section 23 (f). Nor is the \$50,000 deductible as an ordinary and necessary business expense in 1932. While the payment is not an ordinary business expense, even if it were so considered, it accrued in 1931 at the time it was incurred and paid and could not be deducted in 1932 under Section 23 (a).

## ARGUMENT

## I

**Taxpayer Is Not Entitled to Deduct in 1932 \$171,795.26  
Representing the Part of the Hackfeld Litigation Expenses  
Paid by It**

The expenses of the Hackfeld litigation totaled \$568,-607.76. Of this amount \$396,812.50 was contributed in 1924, 1925, and 1926 by the taxpayer's codefendants in the litigation (R. 198-200) and was paid in years prior to 1932 (R. 198). Of the remaining \$171,795.26, which was taxpayer's share of the expenses and was paid by it, \$83,802.76 was paid in years prior to 1932, and \$87,992.50 was paid in 1932. (R. 198.) The District Court allowed deduction in 1932 of taxpayer's total share of the expenses regardless of when paid, but denied deduction in 1932 of the \$396,812.50 returned by taxpayer to its codefendants in that year. The \$396,-812.50 item will be shown to have been correctly disallowed in Point II, *infra*. This point will be devoted to the \$171,795.26 part of the expenses paid by the taxpayer. It is our position that the District Court erred in allowing deductions for the \$87,992.50 paid in 1932 and the \$83,802.76 paid prior to 1932, since there is no showing that any of the expenses accrued in 1932 so as to be deductible by taxpayer which reports on the accrual basis of accounting. No contention is made that the litigation expenses paid by the taxpayer were not ordinary and necessary business expenses within the meaning of Section 23 (a) of the Revenue Act of 1932 (Appendix, *infra*). Nevertheless, they are not properly deductible in 1932 under Sections 41 and 43 of the 1932 Act (Appendix, *infra*) since they did not accrue within that year.

Before presenting our argument on the deductibility of the two amounts, some basic principles applicable to all claimed deductions generally are noted. It is settled

that deductions from gross income are not a matter of right but of legislative grace and that the burden is upon the taxpayer claiming a deduction to establish its right thereto, by bringing itself squarely within the terms of the statute authorizing the deduction. *New Colonial Co. v. Helvering*, 292 U. S. 435, 440; *White v. United States*, 305 U. S. 281, 282; *Helvering v. Ind. Life Ins. Co.*, 292 U. S. 371, 381; *Woolford Realty Co. v. Rose*, 286 U. S. 319, 326. Moreover, the ruling of the Commissioner of Internal Revenue that the deductions claimed are not allowable is presumed correct and the taxpayer has the burden of proving it to be wrong. *Welch v. Helvering*, 290 U. S. 111, 115.

A. *The \$83,802.76 paid by taxpayer prior to 1932 cannot be deducted in 1932*

Section 43 of the Revenue Act of 1932 provides that deductions provided for in the income tax title shall be taken for the taxable year in which they were "paid or accrued", dependent upon the method of accounting employed in computing net income. Since the taxpayer kept its books and made its tax returns on the accrual basis of accounting in 1932 and for many years prior thereto (R. 394), it can deduct in 1932 under the statute only the litigation expenses which accrued in 1932.

As shown, the amount of \$83,802.76 out of the total \$171,795.26, representing taxpayer's share of the litigation expenses, was stipulated to have been paid in years prior to 1932. In fact, \$32,513.15 of the amount was paid in 1924; \$26,356.62 in 1925-1926; \$6,255.49 in 1927; \$12.27 in 1928; \$13,313.55 in 1929; \$832 in 1930; and \$4,519.68 in 1931. (R. 198-200.) Since the \$83,802.76 had been paid in its entirety prior to 1932, it is not possible to conclude that the amount accrued in 1932. As the Court of Claims said in *Chestnut Securities Co. v. United States*, 62 F. Supp. 574, 576, with respect to a

taxpayer which paid an asserted liability for state taxes but immediately commenced an unsuccessful suit for their refund:

It is hardly conceivable that a liability asserted against him, which he has discharged by payment, has not yet "accrued" within the meaning of the tax laws and the terminology of accounting. Accrual, from the debtor's standpoint, precedes payment, and does not survive it.

In this case, although the District Court permitted deduction of the \$83,802.76 in 1932, it made no findings which would support a conclusion that the amount accrued as a liability in 1932. The District Court found that the taxpayer carried the total litigation expenses of \$568,607.76 as deferred items on its books until after conclusion of the litigation (R. 77), but it made no finding as to the reason for doing so, and the mere fact that taxpayer carried the expenses as deferred items after they had actually been paid does not warrant a conclusion that the *paid expenses* had not accrued at the time they were paid. An expense accrues for deduction purposes at the time the events occur which determine the liability to pay and fix the amount, even though the amount has not then been ascertained. *United States v. Anderson*, 269 U. S. 422, 441; *Brown v. Helvering*, 291 U. S. 193, 200. It is certainly not to be inferred that a debtor will pay amounts for which his liability has not become fixed within reasonable limits, and indeed if he did so, the payment might well not be considered as a deductible expense but rather more in the nature of a gift or contribution.

The facts here in any case compel the conclusion that the liability for the payments made prior to 1932 had accrued prior to 1932. The Hackfeld suit was commenced in 1924 and in January of 1927, judgment in favor of taxpayer and its codefendants was entered by



the trial court. Approximately \$450,000 of the total expenses of \$568,607 was paid in the years 1924-1926, inclusive (R. 198), quite apparently for the preparation of the defense and the trial. The appeal to the Supreme Court of California was concluded in 1931, except for the denial in January, 1932, of the motion to recall the remittitur which had been filed in August, 1931. Obviously the preparation and work in connection with the appeal had been completed in 1931 and the payments of expenses made in the years 1927-1931, inclusive, must be deemed to have accrued in connection with such work, and other items in connection with the litigation up to that point. There is no proof whatever that the pre-1932 payments covered services to be performed in 1932, or expenses to be incurred in 1932.

Since the amount of \$83,802.76 was paid by taxpayer prior to 1932 and the taxpayer has failed to show that the amount did not accrue as a liability until 1932, it follows that the District Court erred in allowing the amount as a deduction in 1932.

*B. The \$87,992.50 paid by taxpayer in 1932 was not shown to be deductible in 1932*

The Commissioner disallowed deduction of all the litigation expenses (\$171,795.26) paid by taxpayer, including the \$87,992.50 paid in 1932, for the reason that there was no evidence that any of the services for which payment was made in 1932 had actually been rendered in that year but that the evidence indicated that practically all the legal fees and expenses had been incurred prior to 1932. (R. 577-578, Deft. Ex. B.) As shown above, this determination is presumed correct and the taxpayer had the burden of showing that the expenses actually had been incurred and that they accrued in 1932. It wholly failed to make this showing and in fact



the record strongly indicates that the expenses paid in 1932 actually accrued prior to that time.

As already pointed out, the trial court entered judgment for the defendants in January, 1927, the judgment was affirmed on appeal on April 30, 1931; and petition for rehearing was denied on May 28, 1931. Thereafter on August 26, 1931, a motion to recall the remittitur was filed, which was denied by the Supreme Court of California on January 29, 1932. On April 25, 1932, a petition for certiorari was denied by the Supreme Court. This history of the litigation makes it highly doubtful that any expenses in connection with it were incurred in 1932. Even the expenses, if there were any which the record does not show, in connection with defending against the motion to recall the remittitur must necessarily have accrued in 1931. It was not shown on what date the petition for certiorari was filed, what fees and expenses, if any, were incurred in opposing it, and if fees and expenses were incurred, whether they accrued in 1931 or 1932.

Furthermore, the record discloses that the last payment of a fee to the attorneys in the Hackfeld litigation prior to 1932 was on March 23, 1926, when \$50,000 was paid Sutro. (R. 272.) An \$85,000 fee was paid to him on July 28, 1932, but since no fee had been paid since 1926, since fees had undoubtedly accrued in the interval in defending the appeal which, as shown, terminated in 1931, and since the record does not show that the attorneys performed any services in 1932, the inference is required, for lack of proof to the contrary by the taxpayer having the burden of proof, that the fee paid in 1932 was incurred for services performed prior thereto. In this connection, it is noted that there is no evidence of record that the contract with the attorneys made the amount of their fees or the payment thereof contingent

upon the final outcome or upon the final termination of the litigation.

It is clear that the taxpayer failed to carry its burden of showing that the \$87,992.50 of expenses accrued in 1932 and that the District Court erred under Section 43 of the Code in allowing a deduction in 1932 for that amount to the taxpayer.

## II

### **The District Court Correctly Disallowed a Deduction in 1932 of \$396,812.50**

During the years 1924-1926 \$396,812.50 of the total expenses of \$455,682.27 paid in those years in defending the Hackfeld suit was determined to be the share of the stockholders of taxpayer who were defendants in the suit and who had agreed among themselves to bear their share of the expenses *pro rata* if they were named defendants. The stockholders actually contributed the amount of \$396,812.50 to the expenses from 1924 through January, 1926. After certiorari was denied in April, 1932, the taxpayer repaid the \$396,812.50 to the stockholders without legal obligation or liability to do so, as the District Court found. It correctly denied deduction of the \$396,812.50 in 1932 as an ordinary and necessary business expense under Section 23 (a) of the Revenue Act of 1932.

The taxpayer's contention (Br. 38-39) that the District Court erred in not allowing deduction of the amount seems to rest on two theories: First, that upon the successful termination of the litigation in 1932 there arose an obligation on taxpayer's part to reimburse its stockholders for the expenses previously paid by them since the stockholders were found not to have been guilty of the acts charged against them in the suit; and second, that until the conclusion of the litigation it was impossible to determine whether taxpayer

or the stockholders were liable to pay the expenses, and the expenses of \$396,812.50 therefore accrued as a liability of the taxpayer only after denial of the petition for certiorari in 1932. There is no merit to either argument.

Section 23 (a) of the Revenue Act of 1932 permits deduction of only the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any business. The amount of \$396,812.50 of the litigation expenses was not incurred in carrying on the taxpayer's business and it was not an ordinary and necessary expense of the taxpayer's business so that it does not meet the requirements for deduction set out in Section 23 (a). Further, this part of the expenses did not accrue within 1932 so as to be deductible in 1932, even if, contrary to the fact, it were assumed *arguendo* that the expenses represented ordinary and necessary business expenses of the taxpayer's business which may be deducted in the proper year.

*A. The amount was not paid or incurred in carrying on the taxpayer's business*

At the outset it is again pointed out that the parties themselves determined that \$396,812.50 of the total litigation expenses in the earlier years represented the amount allocable to the defense of the stockholders against the claims for their stock in taxpayer and for damages and the charges asserted against them in the suit. (R. 78-79.) Similarly, the remainder of the total expenses in the earlier years was allocated by the parties as applicable to the defense of taxpayer from the charges against it, the damages claimed from it, and the protection of its property. We do not understand that taxpayer contends now that that apportionment of the expenses was incorrect or unfair. Rather its contention is that, when the termination of the

litigation established the innocence of the stockholders as to the charges against them, taxpayer became obligated to reimburse the stockholders for the expenses paid by them in defending the charges against them, or alternatively that the expenses incurred in defending the stockholder-incorporators accrued at that time as expenses of the taxpayer.

Both contentions fail, for considered in either aspect the portion of the expenses paid or incurred in the defense of charges and claims against the stockholder-incorporators was in no sense paid or incurred in carrying on the taxpayer's business. Its business was the sugar agency and factor business and this business could not conceivably include the original payment of, or the reimbursement of the stockholder-incorporators for, expenses incurred in defending the stockholder-incorporators against charges of fraud and conspiracy alleged to have been committed by them *before the taxpayer was organized and before it engaged in any business*, and also in *protecting the stockholders' investment in taxpayer's stock*. Such expenses, as distinguished from the part of the expenses incurred to defend the taxpayer from the charges and claims against it, were the personal expenses of the stockholders and were wholly unrelated to the taxpayer's business. They neither were "directly connected with", nor "proximately resulted from", the taxpayer's business, and thus they do not qualify as a deductible business expense of the taxpayer. See *Kornhauser v. United States*, 276 U.S. 145, 153.

This conclusion is required by the decided cases. In *Hales-Mullaly, Inc. v. Commissioner*, 131 F. 2d 509 (C.A. 10th), as in the case at bar, the taxpayer corporation was joined with its incorporators as defendants in a suit for damages based on the alleged fraud and conspiracy of the incorporators in forming the tax-



payer.<sup>4</sup> The court held that the taxpayer corporation could not deduct the litigation expenses incurred in connection with the suit on the ground that the expenses were not ordinary expenses incurred in carrying on a business. The court said (p. 512):

Moreover, since the fraud was committed by the individuals prior to the organization of the taxpayer, and prior to the time it first engaged in business, the liability or obligation asserted in the suit was not incurred in carrying on the business, within the meaning of the statute. \* \* \*

See also *Blackwell Oil & Gas Co. v. Commissioner*, 60 F. 2d 257 (C.A. 10th), and *Knight-Campbell Music Co. v. Commissioner*, 155 F. 2d 837 (C.A. 10th). Cf. *White v. Commissioner*, 61 F. 2d 726 (C.A. 9th); *A. Giurlani & Bro. v. Commissioner*, 119 F. 2d 852, 856-857 (C.A. 9th); *Pantages Theatre Co. v. Welch*, 71 F. 2d 68, 69 (C.A. 9th); *Robinson v. Commissioner*, 53 F. 2d 810, 811 (C.A. 8th).

Compare also *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, and *South American Gold & Platinum Co. v. Commissioner*, 8 T.C. 1297, affirmed

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<sup>4</sup> In the *Hales-Mullaly* case, as the court pointed out (p. 512), the suit was bottomed on fraud committed by the individuals antecedent to the existence of the taxpayer and the taxpayer's liability, if any, arose solely from its receiving and retaining the benefits of the fraud of the individuals who organized it. In the case at bar, however, damages were also claimed against the corporate taxpayer as a result of its mismanagement, after its organization and while engaged in business, of the business and assets acquired from Hackfeld. Thus, unlike the *Hales-Mullaly* case, in this case the total expenses of the litigation were apportioned between the stockholder-incorporators and the taxpayer. As already indicated, no contention is made that the expenses incurred in defending against the charges and claims made against the taxpayer are not ordinary business expenses of the taxpayer. The issue under this point relates solely to the expenses incurred in defending the stockholder-incorporators from the charges and claims made against them and this issue is parallel to that decided in the *Hales-Mullaly* case.



*per curiam*, 168 F. 2d 71 (C.A. 2d), in which a parent corporation was not permitted to deduct amounts paid by the parent representing, respectively, operating deficits and legal expenses of a wholly-owned subsidiary corporation. Clearly, if the payment of a subsidiary's deficit or expense cannot be deemed to be a business expense of the parent, even where the wholly-owned subsidiary incurred it in a business operated exclusively for the benefit of the parent, it follows *a fortiori* that the expenses of protecting the property of the taxpayer's stockholders and of defending them against charges of fraud and conspiracy cannot be considered expenses of the taxpayer's business.

*B. The expenses were not ordinary and necessary*

Not only were the expenses incurred in defending the stockholder-incorporators not incurred in carrying on the taxpayer's business, but the expenses were not ordinary and necessary expenses of its business, so as to permit a deduction under Section 23 (a). The District Court so held.<sup>5</sup>

It may be assumed that in 1932 taxpayer deemed it a moral obligation and thus "necessary" that it bear the litigation expenses incurred in defending its stockholders, but that is not sufficient under the statute. The expense must also be "ordinary". *Welch v. Helvering*, 290 U. S. 111; *Deputy v. du Pont*, 308 U. S. 488.

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<sup>5</sup> Taxpayer's statement (Br. 35) that the District Court held that all of the litigation expenses are ordinary and necessary business expenses is not understood. The District Court specifically concluded (R. 101):

The sum of \$396,812.50 of the Hackfeld litigation expenses which plaintiff refunded or repaid in the year 1932 to those persons and corporations who were co-defendants with plaintiff in said litigation *were not ordinary and necessary expenses* paid or incurred during the taxable year 1932 by plaintiff *in carrying on its business*. \* \* \* (Italics supplied.)

The test to be applied in determining whether an expenditure is "ordinary" within the meaning of Section 23 (a) was made clear by the Supreme Court in *Deputy v. du Pont, supra*, in the following language (pp. 495-496):

Ordinary has the connotation of normal, usual, or customary. To be sure, an expense may be ordinary though it happen but once in the taxpayer's lifetime. Cf. *Kornhauser v. United States, supra*. Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved. *Welch v. Helvering, supra*, 114. Hence, the fact that a particular expense would be an ordinary or common one in the course of one business and so deductible under § 23 (a) does not necessarily make it such in connection with another business. Thus, it has been held that one who was an active trader in securities might take as deductions carrying charges on short sales since selling short was common in that business. But the carrying charges on respondent's short sale in this case cannot be accorded the same privilege under § 23 (a). The record does not show that respondent was in the business of trading in securities. Nor does it show that a stockholder engaged in conserving and enhancing his estate ordinarily makes short sales or similarly assists his corporation in financing stock purchase plans for the benefit of its executives. As stated in *Welch v. Helvering, supra*, pp. 113-114: ". . . What is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance." One of the extremely relevant circumstances is the nature and scope of the particular business out of which the expense in question accrued. The fact that an obligation to pay has arisen is not sufficient. *It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling.* (Italics supplied.)

Applying those principles to the facts here, it is obvious that the payment of the expenses of defending the stockholder-incorporators and their property from damages asserted as a result of their acts is not a usual or normal expense of carrying on a sugar agency and factoring business, or indeed of any commercial business. It was so decided in *Hales-Mullaly, Inc. v. Commissioner*, 131 F. 2d 509 (C. A. 10th). Indeed, the law is well settled that a taxpayer may not deduct as an ordinary and necessary business expense the payment of the liabilities of others.<sup>6</sup> *Welch v. Helvering*, 290 U. S. 111; *A. Giurlani & Bro. v. Commissioner*, 119 F. 2d 852 (C. A. 9th); *White v. Commissioner*, 61 F. 2d 726 (C. A. 9th); *Pantages Theatre Co. v. Welch*, 71 F. 2d 68 (C. A. 9th); *Blackwell Oil & Gas Co. v. Commissioner*, 60 F. 2d 257 (C. A. 10th); *Robinson v. Commissioner*, 53 F. 2d 810, 811 (C. A. 8th); *One Hundred Five West Fifty-Fifth St. v. Commissioner*, 42 F. 2d 849, 852 (C. A. 2d).

Moreover, even though taxpayer may have felt morally obliged to bear the portion of the expenses incurred in defending the stockholders, in addition to the part of the expenses incurred in defending itself, there was no legal obligation to do so. Taxpayer's argument (Br. 41-42, 48-49) that a corporation is liable for the defense of legal proceedings brought against its officers, agents, or members of its committees if the corporation has an interest in the litigation is not applicable to the facts of this case, since the codefendants in the Hackfeld litigation were not sued as officers, employees, or agents of the taxpayer. They were sued as the persons who organized the taxpayer for acts done prior to and in taxpayer's organization. A cor-

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<sup>6</sup> The liabilities which the taxpayer thus discharged by its reimbursement were the liabilities of others. Cf. *Matson Navigation Co. v. Commissioner*, 24 B.T.A. 14.

of the argument only, it will be assumed, although we have conclusively demonstrated otherwise, that the expenses were ordinary and necessary expenses of taxpayer's business and that they are properly deductible by taxpayer in the year in which they accrued.

The record shows that the \$396,812.50 of the Hackfeld litigation expenses here in issue were collected by taxpayer from its codefendants and were paid at different periods from 1924 to 1926. (R. 198-200.) There is nothing in the record to show that the expenses had not been incurred and had not accrued at the time they were paid. Indeed, as was suggested under Point I, above, it is probably impossible to establish that an expense which has been paid accrues only at a later date. *Chestnut Securities Co. v. United States*, 62 F. Supp. 574 (C. Cls.).

Although the expenses were actually paid by the codefendants in 1924-1926, there is no reason, if the expenses were expenses for which taxpayer was legally or equitably liable as it contends, why taxpayer's liability to reimburse the stockholders did not accrue at that time. To be sure, taxpayer insists that its liability existed only if the codefendants were not guilty of the charges against them and this was not finally determined until 1932, but it cites no authority which supports a view that liability existed only if the incorporators were not held liable for fraud. *Blackwell Oil & Gas Co. v. Commissioner*, 60 F. 2d 257 (C. A. 10th) (cited Br. 40-41), is authority for the view that a corporation may not deduct as an ordinary business expense the expenses of defending its directors, not its incorporators, from a suit charging conspiracy, since the corporation was not legally responsible for defending a personal suit against them based on their unauthorized acts. But as pointed out, the stockholder-incorporators were not directors, agents, or employees of the taxpayer,



which had not been organized at the time the acts complained of were performed, so that the question of whether they were acting within the scope of the authority given them by taxpayer does not arise here. No authority cited by taxpayer touches on whether a corporation is liable for the acts of its incorporators. Furthermore, taxpayer accepted without question the benefits of their acts done prior to its incorporation, so that it is hardly in a position to contend that it was liable for the expenses of their defense only if they were not guilty of the fraud and conspiracy charged. If taxpayer was liable at all for their share of the expenses as taxpayer insists that it was if judgment was rendered in their favor in the Hackfeld litigation, then it is submitted that taxpayer was liable regardless of the outcome of the litigation. The liability was then incurred and accrued in 1924-1926, and the deduction, if otherwise properly allowable, cannot be taken in 1932.

For all of the foregoing reasons, the District Court's judgment denying the deduction of \$396,812.50 in 1932 was correct, and should be affirmed.

### III

**The District Court Did Not Err in Denying the Taxpayer a Deduction in 1932 for the \$50,000 Payment in 1931 Into the Fund for the Henry Waterhouse Trust Company**

*A. The payment of \$50,000 did not create a valid debt*

It is elementary that the allowance of a deduction for a bad debt presupposes the existence of a valid debt arising out of a debtor-creditor relationship. *Harmount v. Commissioner*, 58 F. 2d 118 (C.A. 6th); *Milton Bradley Co. v. United States*, 146 F. 2d 541, 542 (C.A. 1st); *Estate of Van Anda v. Commissioner*, 12 T.C. 1158, 1162. The giving of a note or other evidence of indebtedness which may be legally enforceable is not



in itself conclusive of the existence of a bona fide debt. *Montgomery v. United States*, 23 F. Supp. 130 (C. Cls.), certiorari denied, 307 U.S. 632; *Estate of Van Anda v. Commissioner*, *supra*; *Wolff v. Commissioner*, 26 B.T.A. 622; *Griffiths v. Commissioner*, 25 B.T.A. 1292; *Hayes v. Commissioner*, 17 B.T.A. 86.

A conditional obligation does not give rise to a debt. *Shiman v. Commissioner*, 60 F. 2d 65, 66 (C.A. 2d); *Milton Bradley Co. v. United States*, *supra*, p. 542; *S. Naitove & Co. v. Commissioner*, 32 F. 2d 949 (C.A. D.C.); *Wolff v. Commissioner*, *supra*, p. 626. This principle was explained by the First Circuit in the *Milton Bradley Co.* case as follows (p. 542):

One of the underlying conditions of validity is an unconditional obligation of the debtor to pay the creditor. "The debts which the statute permits to be charged off when ascertained to be worthless are debts where there is an obligation of the debtor to pay and a right of the creditor to receive and enforce payment." *J. S. Cullinan v. Commissioner of Internal Revenue*, 19 B.T.A. 930. "The sine qua non of a debt is the obligation to pay. \* \* \* And this means not a contingent obligation, \* \* \*." *Wolff v. Commissioner of Internal Revenue*, 26 B.T.A. 622, 626, and cases cited. The liability to pay in the future, contingent upon something which may or may not occur, is not indebtedness, and the taxpayer may not treat as worthless debts amounts which are at a particular time merely contingent liabilities. *Eckert v. Burnet*, 1931, 283 U.S. 140, 51 S. Ct. 373, 75 L. Ed. 911; *S. Naitove & Co. v. Commissioner of Internal Revenue*, 1929, 59 App. D.C. 53, 32 F. 2d 949; *Wolff v. Commissioner*, *supra*. Where the liability to pay is not absolute, the existence of a deductible debt has not been accepted. *Howell v. Commissioner of Internal Revenue*, 8 Cir., 1934, 69 F. 2d 447, certiorari denied *Howell v. Helvering*, 1934, 292 U.S. 654, 54 S. Ct. 864, 78 L. Ed. 1503; *American Cigar Co. v. Commissioner of*

*Internal Revenue*, 2 Cir., 1933, 66 F. 2d 425, certiorari denied 1933, 290 U.S. 699, 54 S. Ct. 209, 78 L. Ed. 601; *In re Park's Estate*, 2 Cir., 1932, 58 F. 2d 965, certiorari denied, 1932, *Park's Estate v. Commissioner of Internal Revenue*, 287 U.S. 645, 53 S. Ct. 91, 77 L. Ed. 558. \* \* \*

The District Court in this case concluded (R. 102) that the payment of \$50,000 to Waterhouse in 1931 was just a contribution by taxpayer, that the note given was contingent as to payment and subject to such conditions as to render it without negotiable value at any time, and that it therefore cannot be dealt with as a debt. If the note was contingent as to payment, the District Court was manifestly correct under the cited authorities<sup>7</sup> in concluding that it was not a "debt" which can be the basis of a deduction for a bad debt under Section 23 (j) of the Revenue Act of 1932 (Appendix, *infra*).

It is plain that the finding that the note was contingent as to payment could not be successfully challenged, and the taxpayer does not attempt to do so. The note given to taxpayer by Waterhouse had a proviso which read (R. 90, 410)—

\* \* \* payment of principal and interest to be made only when, if and to the extent that there

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<sup>7</sup> The cases of *Clay Drilling Co. v. Commissioner*, 6 T.C. 324, and *Western Woodwork & Lumber Co. v. Commissioner*, decided May 9, 1947 (1947 P-H T.C. Memorandum Decisions, par. 47,124), are cited by taxpayer (Br. 61-65) as authority to the contrary. The issue in the *Clay* case was whether a valid indebtedness had been cancelled and forgiven in an earlier year as a result of an agreement under which the debt became payable only in the manner agreed upon. The Tax Court held that it was not cancelled. While the *Western* case did apparently rule that a note represented a debt despite the contingent nature of its payment, no deduction for a bad debt was allowed in 1943 because the note became worthless in an earlier year. To the extent that the unreviewed memorandum opinion of the Tax Court in the *Western* case is contrary to the authorities cited above, it is against the clear weight of authority and is, we submit, incorrect.

shall be funds available therefor as set forth in letter of this date from the payor to the payee.

The conditions stated in the letter (R. 85-90, 402-407) were that payment was to be made only after expenses of the liquidation, \$1,000 per month to Bishop for supervision, interest, indebtedness, and other liabilities were paid in that order, and after Bishop was reimbursed for the amounts contributed by it, if any, required (in excess of the \$1,035,000) to liquidate Waterhouse's liabilities. The fact that the note was not absolute as to payment is alone enough to require the finding that no debt sufficient to support a deduction under Section 23 (j) was created.

Moreover, it has been repeatedly held that advances voluntarily made without expectation of repayment do not create a "debt" which can provide the basis for a bad debt deduction. *Spring City Co. v. Commissioner*, 292 U.S. 182, 189; *Porter v. United States*, 27 F. 2d 882 (C.A. 9th); *American Cigar Co. v. Commissioner*, 66 F. 2d 425 (C.A. 2d), certiorari denied, 290 U.S. 699; *W. F. Young, Inc. v. Commissioner*, 120 F. 2d 159 (C.A. 1st); *Busch v. Commissioner*, 50 F. 2d 800 (C.A. 5th); *Menihan v. Commissioner*, 79 F. 2d 304 (C.A. 2d); *Hayes v. Commissioner*, 17 B.T.A. 86, 87; *Wolff v. Commissioner*, 26 B.T.A. 622; see particularly, *Davis v. Commissioner*, decided November 3, 1937 (1937 P-H B.T.A. Memorandum Decisions, par. 37,312); *McLeod v. Commissioner*, 19 B.T.A. 134, 139.

That principle is applicable here in support of the conclusion that no real debt was created. The District Court found that the payment of \$50,000 was merely a contribution without expectation of repayment, other than preventing Waterhouse from closing due to its insolvent condition and protecting the commercial community and Waterhouse's clients who could ill afford to lose. (R. 60-61, 96, 102-103.) These

findings are clearly correct when all the circumstances existing at the time that taxpayer was solicited to contribute to the fund and agreed to do so are taken into account. Although taxpayer argues (Br. 57-61) that the findings in this respect are erroneous, the testimony of the witnesses relied on (Br. 59-60) at most indicates that some of those who contributed expected and hoped that some part of the contributions would not be needed and would be returned. Facts with respect to Waterhouse's financial position in 1931 to support such a hope were not shown; the Waterhouse balance sheet and the audit report prepared at the time based on book figures (R. 91-95) were not shown to represent the actual value of the assets. And it is obvious from the whole record that the contributions were made for the principal purpose or motive of preventing Waterhouse's failure, irrespective of whether the contributions might be returned in whole or in part. Indeed, taxpayer apparently concedes (Br. 66) that the motive for "advancing" the money was the protection of the commercial community as the District Court found, but argues that the reason for making the advance and its wisdom from the standpoint of being repaid are not pertinent. Such matters of course are material on the question of whether the payment was voluntarily made without expectation of repayment, and the District Court's finding here on that question is amply supported and is correct.

There was no evidence that taxpayer would have lost anything through Waterhouse's failure if it had not contributed to the fund, as the District Court found (R. 96), and the contribution was not therefore required to protect an existing indebtedness, investment or claim against Waterhouse. This is additional confirmation that the contribution was voluntarily made.



It is submitted that the District Court's finding that the taxpayer's payment of \$50,000 into the Waterhouse fund was not a debt was correct and should be affirmed.

*B. The debt was not ascertained to be worthless in 1932*

The District Court concluded that no part of the \$50,000 was deductible as a bad debt ascertained to be worthless and charged off within the taxable year 1932 within the terms of Section 23 (j) of the Revenue Act of 1932. (R. 103.)

Even if it is assumed, *arguendo* only, that the payment of the \$50,000 into the Waterhouse fund created a valid debt, we believe the evidence clearly supports the District Court's conclusions stated above. The record discloses that a reserve of \$680,803.15 was set up on the books of Waterhouse as at February 14, 1931, after the reorganization against which all liquidating and operating losses were to be charged. (R. 94-95.) The District Court made a finding of fact (to which the taxpayer does not express any disagreement) which reads as follows (R. 95) :

At December 31, 1931, Henry Waterhouse Trust Company had sustained on liquidation actual losses amounting to \$324,913.77, and at December 31, 1932, it had sustained on liquidation cumulative actual losses totalling \$410,345.80, so that at the end of 1932 there was still a balance of \$190,457.35 remaining in the Reserve for Losses, against which future losses must be paid before there would be any impairment for the repayment of the \$400,000.00 contributions to the special noteholders.

Nevertheless, the taxpayer asserts (Br. 53) that by the end of 1932 it became apparent to it that, by reason of the further reduction in the value of the assets out of which the notes were to be paid, the note held by it



was valueless and was charged off as a loss on its books. The taxpayer relies on a letter dated July 18, 1932, addressed to the noteholders in which Waterhouse informed the taxpayer and other special noteholders that an exhaustive reappraisal disclosed that its liabilities, other than those to the underwriters and stockholders, exceeded the value of its assets by a very considerable amount and expressed the opinion that the \$50,000 note had no value whatever. (R. 413-414.)

Mere reliance upon the opinion stated in that letter as to the alleged valuelessness of Waterhouse's special notes, without more, is not a sufficient ascertainment of worthlessness as to satisfy the statute. It is a fundamental rule that mere statements of opinion as to worthlessness are insufficient to satisfy the statutory requirements, and that the facts with respect to the alleged valuelessness of the notes must be presented to the court so that it may form an independent judgment as to the ascertainment of worthlessness. *Rosenthal v. Helvering*, 124 F. 2d 474 (C. A. 2d); *Georgia Engineering Co. v. Commissioner*, 21 B. T. A. 532, 547-548; *Gano v. Commissioner*, 19 B. T. A. 518. This Court in *American Trust Co. v. Commissioner*, 31 F. 2d 47, held that an investigation which shows only that the debtor is in an unsatisfactory financial condition and that the collection of the debt is doubtful, is not a sufficient ascertainment of worthlessness.

In addition to the letter from Waterhouse mentioned above, the taxpayer refers (Br. 67-71) to the testimony of its witnesses Lowrey and Castle, and Linden, a witness for Alexander & Baldwin, Limited, as support for the assertion in its brief that it ascertained the note to be worthless in 1932 and charged it off. But we submit that their testimony merely indicates that the taxpayer relied upon the opinions of others, and as shown, without investigation and proof of the facts on which the

opinions were based, that is not a sufficient showing of worthlessness.

Reverting to the reappraisal mentioned in that letter which Mr. Castle testified had been made, there is no evidence which shows whether the appraisal was reduced to writing, when it was made, who made it and their qualifications for such a task, and what method they adopted and why. There is no evidence of the details of that appraisal; it is not disclosed what values were used, whether cost or market, and if the latter, as of what date and how such values were determined. Furthermore, there is no evidence which identifies or describes the property appraised, so that it is not disclosed whether the property was physical or intangible property, whether it was subject to depreciation, and if so, when it was acquired and the depreciation sustained to the date of the appraisal. If the property included securities, there is no information as to whether they were listed on any exchanges, the size of the blocks of securities, whether the market therefor was active or inactive. In short, the basis on which the reappraisal was made was not shown and the trial court was therefore not furnished with the facts necessary to enable it to determine that taxpayer's alleged ascertainment of worthlessness of the note was based on facts warranting that conclusion. Indeed, it would seem that if the facts in 1932 justified an ascertainment of worthlessness, the facts would have justified the same conclusion in 1931, since Waterhouse was then apparently insolvent (R. 61) and required substantial assistance to pay off its liabilities. It was not shown that the reappraisal was made in 1932 rather than 1931, but in any case a reappraisal in 1931, would doubtless have disclosed the same situation as existed in 1932.

Despite the assertion to the contrary made in the taxpayer's brief (p. 53), we submit that the evidence of

record indicates clearly that the taxpayer could not have been convinced that the note had become valueless in 1932, assuming *arguendo* of course that taxpayer ever believed that the note had value. As the District Court found, at the end of 1932 the reserve for liquidating losses had not been exhausted. (R. 95.) Also the letter from Waterhouse in 1932 contained the following (R. 414):

Despite the worthlessness of the note it remains an apparent liability of this Company and operates as a hindrance to its speedy liquidation, especially as so long as it remains on our books the Advisory Committee will have to be continued. *Hence we suggest that you concede the worthlessness of the note by formally authorizing this Company to consider that it is no longer an obligation.* (Italics supplied.)

It was stipulated that the advisory committee was not abrogated but continued to function as usual during the balance of 1932 and the year 1933. (R. 390-391.) Lowrey testified that the taxpayer did not make a formal reply to the Waterhouse letter. (R. 474-475.) Not only did the taxpayer refuse to comply with the request of Waterhouse that it formally concede that the note was worthless and surrender it to Waterhouse, but the other note-holders likewise refused to do so. (R. 517.) Yet, for federal income tax purposes, the taxpayer seeks relief here on the ground that it ascertained the note to be worthless in 1932, having refused, however, to make such a concession to Waterhouse. The fact that it charged off the note as a loss on its books is insufficient. *Spring City Co. v. Commissioner*, 292 U. S. 182, 189.

In view of the foregoing, we believe the District Court's conclusions are fully supported by the evidence and should be sustained.

*C. Neither is the \$50,000 paid to Waterhouse deductible as a loss sustained or as an ordinary and necessary business expense of the taxpayer in 1932*

In the alternative, the taxpayer maintains (Br. 69-75) that the District Court should have allowed it to deduct the \$50,000 as a business loss or as an ordinary and necessary business expense in the year 1932.

Section 23 (f) of the Revenue Act of 1932 (Appendix, *infra*) permits corporations to deduct losses sustained during the taxable year if not compensated for by insurance or otherwise. No loss was sustained by taxpayer in 1932 which may be deducted under this section, as the District Court held. (R. 103.)

As previously pointed out, the District Court found that the payment was voluntary, and was a contribution made without expectation of repayment. (R. 60-61, 64-65, 96, 102-103.) The loss, *if any*, from the contribution was therefore sustained when the payment was made, in 1931, rather than in 1932, although we believe that a contribution in the circumstances here could not form the basis for a deduction of a loss at any time. Cf. *Commissioner v. Gilt Edge Textile Corp.*, 173 F. 2d 810 (C. A. 3d); *Uhl Estate Co. v. Commissioner*, 116 F. 2d 403 (C. A. 9th).

Furthermore, in view of the District Court's finding of fact that at the end of 1932 there was still a balance of \$190,457.35 remaining in the reserve for losses against which future losses must be charged before there would be any impairment for the repayment of the \$400,000 contributions to the special noteholders (R. 95), there can be no doubt that the taxpayer did not sustain any loss during the taxable year 1932 in respect to its contribution to that fund. See *McLeod v. Commissioner*, 19 B. T. A. 134, 139, appeal dismissed



on September 25, 1931, by Court of Appeals for the First Circuit without written opinion. No identifiable event occurred in 1932 which fixed a loss deductible from gross income. *United States v. White Dental Co.*, 274 U. S. 398. Cf. *A. Giurlani & Bro. v. Commissioner*, 119 F. 2d 852, 857 (C. A. 9th).

Since we have fully discussed under Point II of this brief what are deemed to be ordinary and necessary expenses of carrying on business, we think it will suffice here to say that there is no evidence to support a conclusion that the expenditure of the \$50,000 was an ordinary and necessary expense of carrying on the taxpayer's business during the taxable year 1932. It was not usual and customary in the sugar agency and factor business to make a contribution of this sort. On the contrary the contribution was extraordinary in nature. Moreover, the record shows that the money was paid into the fund in 1931 (R. 60-61, 96, 398, 464), and that taxpayer's liability to contribute the amount was fixed in 1931 by its unconditional promise to pay (R. 84). As the taxpayer's books are kept on the accrual basis of accounting (R. 394), it could not accrue this expenditure as an expense of doing business in the year 1932 when its liability became fixed and thus accrued in 1931 and the payment was actually made in that year. Cf. *Chestnut Securities Co. v. United States*, 62 F. Supp. 574 (C. Cls.).

In *Robert Gaylord, Inc. v. Commissioner*, 41 B. T. A. 1119, and *Moloney Electric Co. v. Commissioner*, 42 B. T. A. 78, relied on by taxpayer here (Br. 71-74), the Tax Court reached a conclusion on the facts there that contributions similar to those here could be deducted as an ordinary and necessary business expense in 1936. It does not appear that the corporations in those cases were on the accrual basis of accounting and the con-



*C. Neither is the \$50,000 paid to Waterhouse deductible as a loss sustained or as an ordinary and necessary business expense of the taxpayer in 1932*

In the alternative, the taxpayer maintains (Br. 69-75) that the District Court should have allowed it to deduct the \$50,000 as a business loss or as an ordinary and necessary business expense in the year 1932.

Section 23 (f) of the Revenue Act of 1932 (Appendix, *infra*) permits corporations to deduct losses sustained during the taxable year if not compensated for by insurance or otherwise. No loss was sustained by taxpayer in 1932 which may be deducted under this section, as the District Court held. (R. 103.)

As previously pointed out, the District Court found that the payment was voluntary, and was a contribution made without expectation of repayment. (R. 60-61, 64-65, 96, 102-103.) The loss, *if any*, from the contribution was therefore sustained when the payment was made, in 1931, rather than in 1932, although we believe that a contribution in the circumstances here could not form the basis for a deduction of a loss at any time. Cf. *Commissioner v. Gilt Edge Textile Corp.*, 173 F. 2d 810 (C. A. 3d); *Uhl Estate Co. v. Commissioner*, 116 F. 2d 403 (C. A. 9th).

Furthermore, in view of the District Court's finding of fact that at the end of 1932 there was still a balance of \$190,457.35 remaining in the reserve for losses against which future losses must be charged before there would be any impairment for the repayment of the \$400,000 contributions to the special noteholders (R. 95), there can be no doubt that the taxpayer did not sustain any loss during the taxable year 1932 in respect to its contribution to that fund. See *McLeod v. Commissioner*, 19 B. T. A. 134, 139, appeal dismissed

on September 25, 1931, by Court of Appeals for the First Circuit without written opinion. No identifiable event occurred in 1932 which fixed a loss deductible from gross income. *United States v. White Dental Co.*, 274 U. S. 398. Cf. *A. Giurlani & Bro. v. Commissioner*, 119 F. 2d 852, 857 (C. A. 9th).

Since we have fully discussed under Point II of this brief what are deemed to be ordinary and necessary expenses of carrying on business, we think it will suffice here to say that there is no evidence to support a conclusion that the expenditure of the \$50,000 was an ordinary and necessary expense of carrying on the taxpayer's business during the taxable year 1932. It was not usual and customary in the sugar agency and factor business to make a contribution of this sort. On the contrary the contribution was extraordinary in nature. Moreover, the record shows that the money was paid into the fund in 1931 (R. 60-61, 96, 398, 464), and that taxpayer's liability to contribute the amount was fixed in 1931 by its unconditional promise to pay (R. 84). As the taxpayer's books are kept on the accrual basis of accounting (R. 394), it could not accrue this expenditure as an expense of doing business in the year 1932 when its liability became fixed and thus accrued in 1931 and the payment was actually made in that year. Cf. *Chestnut Securities Co. v. United States*, 62 F. Supp. 574 (C. Cls.).

In *Robert Gaylord, Inc. v. Commissioner*, 41 B. T. A. 1119, and *Moloney Electric Co. v. Commissioner*, 42 B. T. A. 78, relied on by taxpayer here (Br. 71-74), the Tax Court reached a conclusion on the facts there that contributions similar to those here could be deducted as an ordinary and necessary business expense in 1936. It does not appear that the corporations in those cases were on the accrual basis of accounting and the con-

tributions there were actually paid in 1936, the year in which allowed, although they had been deposited in a bank in 1931 where they were held, drawing interest, until needed by the bank being liquidated. Thus, those decisions, whatever view is taken as to their validity, are not authority for allowing the deduction to this taxpayer in 1932, where the liability for the contribution accrued and the contribution was paid in 1931.

The taxpayer in its brief (p. 75) in effect asks this Court to consider the facts found by the Board of Tax Appeals (now the Tax Court) in *Bishop Trust Co. v. Commissioner*, 36 B. T. A. 1173, and *Bishop Trust Co. v. Commissioner*, 47 B. T. A. 737, as facts for purposes of this case. While we think that the Board found no facts which assist the taxpayer's position in this case, nevertheless it is submitted that the Court may not look to the findings in those cases involving a different taxpayer to supplement the record in this case. The taxpayer's burden of proof required it to prove in this case whatever facts were necessary to support its claims for refund of the tax paid.

In view of the foregoing, we submit that the District Court's conclusions were correct and should not be disturbed.

## CONCLUSION

The decision of the court below as to the deductibility of \$171,795.26 of the Hackfeld litigation expense on the undisputed facts of the case is erroneous and contrary to law and the authorities, and therefore should be reversed.

The decision of the court below as to the other issues involved should be affirmed.

Respectfully submitted,

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APRIL, 1950.

## APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses*.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, \* \* \*

\* \* \* \* \*

(f) *Losses by Corporations*.—Subject to the limitations provided in subsection (r) of this section in the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

\* \* \* \* \*

(j) *Bad Debts*.—Debts ascertained to be worthless and charged off within the taxable year \* \* \*

\* \* \* \* \*

SEC. 41. GENERAL RULE

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayers; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. \* \* \*

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to



clearly reflect the income the deductions or credits should be taken as of a different period.

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 121. *Business expenses*.—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 141-272. \* \* \*

ART. 171. *Losses*.—\* \* \*

Subject to the limitations on losses from sales or exchanges of stocks and bonds provided in section 23 (r) and article 272, losses sustained by corporations during the taxable year and not compensated for by insurance or otherwise are also fully deductible.

Losses must usually be evidenced by closed and completed transactions. \* \* \*

\* \* \* \* \*

ART. 191. *Bad debts*.—\* \* \*

Where all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. No deduction shall be allowed for the part of a debt ascertained to be worthless and charged off prior to January 1, 1921, unless and until the debt is ascertained to be totally worthless and is finally charged off or is written down to a nominal amount, or the loss is determined in some other manner by a closed and completed transaction. Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be

able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. \* \* \*

\* \* \* \* \*

ART. 321. *Computation of net income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See articles 331-333.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

ART. 341. *"Paid or incurred" and "paid or accrued."*—The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in Title I must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued"

or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Act, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

ART. 342. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. (But see section 117 and articles 651-655.) A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. \* \* \*



No. 12,391

IN THE

United States Court of Appeals  
For the Ninth Circuit

AGNES M. KANNE, Executrix under the  
Will and of the Estate of Fred H.  
Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, *Appellant*,

vs.

AMERICAN FACTORS, LIMITED (an Hawaiian corporation), *Appellee*,  
and

AMERICAN FACTORS, LIMITED (an Hawaiian corporation), *Appellant*,

vs.

AGNES M. KANNE, Executrix under the  
Will and of the Estate of Fred H.  
Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, *Appellee*.

Upon Appeal from the United States District Court  
for the Territory of Hawaii.

ANSWERING BRIEF ON APPEAL OF AGNES M. KANNE  
AND

REPLY BRIEF ON APPEAL OF AMERICAN FACTORS, LIMITED.

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ANSWERING BRIEF ON APPEAL OF AGNES M. KANNE

AND

REPLY BRIEF ON APPEAL OF AMERICAN FACTORS, LIMITED.

---

A statement of the pleadings and facts disclosing  
the basis upon which it is contended that the District

Court had jurisdiction and that this Court has jurisdiction to review the judgment is set forth on page 2 of brief for appellant, American Factors, Limited, and on page 2 of brief for Agnes M. Kanne.

A statement of the case, presenting the questions involved and the manner in which they are raised, is set forth on pages 3 to 25 of brief for appellant, American Factors, Limited. The statement of the case sets forth a summary of the facts with regard to the appeals of both American Factors, Limited, and Agnes M. Kanne.

The appeal of Agnes M. Kanne raises the one issue of whether the taxpayer is entitled to deduct in 1932 the sum of \$171,795.26 of the Hackfeld litigation expenses as expenses accruing in that year. Of this amount it is claimed by counsel for Agnes M. Kanne that with respect to the sum of \$83,802.76, which was paid by the taxpayer prior to 1932, the expense therefor necessarily had accrued before being paid and, consequently, was not incurred or accrued in 1932. Further, it is contended that there is no proof that the amounts paid prior to 1932 were to cover services performed or expenses to be incurred in 1932. With respect to the balance thereof, in the amount of \$87,992.50, which was paid in 1932, it is contended that the taxpayer has failed, for lack of proof, to establish that said expenses were incurred and accrued in 1932.

On its appeal American Factors, Limited, raises two issues. First, whether it is entitled to the deduction, as an ordinary and necessary expense of carry-

ing on its business in the computation of its income tax liability for the year 1932, of \$396,812.50 of Hackfeld litigation expenses, which amount was reimbursed to its co-defendants in the year 1932. Second, whether it is entitled to a deduction, in the computation of its income tax liability for the year 1932, of the amount of \$50,000.00 advanced by it to Waterhouse Company and charged off as worthless in the year 1932, as a bad debt, as an ordinary and necessary expense of carrying on its business, or as a loss sustained in the year 1932.

With respect to the issues raised by American Factors, Limited, it is contended by counsel for Agnes M. Kanne that that portion of the litigation expense, in the sum of \$396,812.50, was not incurred in carrying on the taxpayer's business and was not an ordinary and necessary expense of the taxpayer's business and, further, that it did not accrue in 1932.

It is the contention of counsel for Agnes M. Kanne, with respect to the deductibility of the sum of \$50,000.00 advanced to Henry Waterhouse Trust Company, that it is not deductible as a bad debt because the note received by it was not payable at all events, but its payment was contingent on the debtor having funds to pay it after all its other liabilities and expenses had been paid, that being contributed to serve the community generally and without expectation of repayment it did not constitute a debt sufficient to support a bad debt deduction, and, in any event, taxpayer failed to prove facts sufficient to enable the Court to determine that taxpayer's ascertainment of

worthlessness was based on sufficient facts to warrant the deduction. Further, that taxpayer did not deem the debt worthless since it declined to concede its worthlessness.

The further contention is made that the payment is not deductible as a loss because it was a voluntary contribution and even if there was a loss it could not be deducted in 1932. Further, that it was not an ordinary and necessary business expense in 1932 and, even if it were, it was incurred and paid in 1931 and could not be deducted in 1932.

---

## ARGUMENT.

### I.

**TAXPAYER IS ENTITLED TO DEDUCT IN 1932, AS AN ORDINARY AND NECESSARY BUSINESS EXPENSE, \$568,607.76 OF THE HACKFELD LITIGATION EXPENSES, REPRESENTING \$171,795.26 PAID BY IT AND ALLOWED AS A DEDUCTION BY THE DISTRICT COURT, AND \$396,812.50 REIMBURSED TO OTHER DEFENDANTS AND DISALLOWED BY THE DISTRICT COURT.**

The opinion of the Court below, with respect to the deductibility of the Hackfeld litigation expense, is in part as follows:

“Certainly, the taxpayer had very substantial interests to protect, and was justified in every way, as a legitimate business outlay, in paying from its own funds during the taxable year of 1932, or earlier years had it chosen to do so, the costs of litigation which imperiled its existence although others were involved in the same litigation as defendants and had much to lose, had the



others not come forward with funds and volunteered to engineer and fight the battle at their own costs and had the taxpayer not accepted this offered payment plan and the volunteered services; either of the parties could have abandoned or modified this plan at any time, but so long as it was adhered to it was binding on both; but the taxpayer was not justified, in the realm of taxation laws and deductibles, to later deduct from taxable income the money it paid to reimburse voluntary contributors for money which they had paid out to clear themselves and this company of fraudulent charges made against them collectively and individually and to protect their property interests, no matter if victory in such defense brought great benefit to the taxpayer as well as to the other named defendants.

As between share owners, of course, within ultra vires limitations, they were empowered to make any desired distribution of the company's funds so long as none was injured.

The taxpayer is entitled to an expense-deduction in its 1932 tax return of the sum of all Hackfeld litigation paid by it prior to the end of 1932, less the amount paid in to it for that purpose by the other defendants. The claim for tax refund on sums reimbursed to voluntary contributors to this litigation fund is denied." (R. 63-64.)

The gist of this opinion is that although taxpayer had substantial interests to protect and was justified in every way, as a legitimate business expense, to pay expenses of litigation which imperiled its existence although others were involved in the same litigation as defendants, it could only deduct in 1932 such expenses,



regardless of when paid by it, as were not paid in to it for that purpose by the other defendants.

It is the contention of taxpayer that the Court correctly ruled that all the Hackfeld litigation expenses are ordinary and necessary business expenses, and that regardless of when paid, the entire amount accrued in 1932 when all the events determining the liability therefor had occurred, but erred in its finding that American Factors, Limited, could not deduct the amounts originally paid in by the other defendants, when the taxpayer reimbursed said other defendants when its liability therefor became certain.

**(A) TAXPAYER IS ENTITLED TO DEDUCT \$171,795.26, REPRESENTING THE PART OF THE HACKFELD LITIGATION EXPENSES PAID BY IT AND ALLOWED AS A DEDUCTION BY THE DISTRICT COURT.**

The entire argument of counsel for Agnes M. Kanne in regard to the deductibility of the Hackfeld litigation expense is based on the assumption that the costs of litigation were apportioned or prorated between the taxpayer on the one hand and the co-defendants on the other hand. There is no basis for such an assumption and the record shows conclusively that such was not the fact.

The record shows that the taxpayer was not a party to the written agreement dated July 28, 1924 (Exh. 1 of Plaintiff's Exh. P-5, R. 202-204), wherein the co-defendants agreed to prorate, on an original per share basis, the expenses of the threatened litigation if they were joined as defendants therein. American Factors was not a party to said agreement (R.

186-187). An examination of the agreement itself shows that said co-defendants, other than American Factors, agreed to contribute and pay on demand such a proportion of *all* of the costs and expenses of every description on a per share basis as may have been already paid or incurred, or shall or may thereafter be paid in connection with the Hackfeld litigation by Allen W. T. Bottomley, C. R. Hemenway, F. C. Atherton and R. A. Cooke acting for all of them (R. 202-203).

The evidence shows that the method followed was that American Factors, Limited, acting as banker for the committee, paid bills approved by it and, when a certain amount of expenses had been incurred, an assessment would be levied, divided by the number of shares, and collections would be made from each of the co-defendants on a per share assessment basis (R. 256-257, 291).

An examination of the Plaintiff's Exh. P-7 (R. 262-275) and Plaintiff's Exh. P-8 (R. 308-310) will disclose that in the year 1924 there was paid by American Factors \$108,450.65, and there was assessed against the co-defendants and collected the amount of \$75,937.50. For the year 1925, there was expended \$198,114.32, or a total to December 31, 1925, of \$306,564.97. As can be seen from Exh. P-8, the last assessment was made in December, 1925, and the total amount paid in the year 1925 by the other co-defendants was \$279,987.50, so that at the end of 1925, although American Factors had paid out only \$306,564.97, it had received from its co-defendants

\$351,925.00. In addition, it received on January 4, 1926, \$9,500.00 from A. W. T. Bottomley, on January 5, 1926, \$8,787.50 from George Sherman, and on January 19, 1926, \$21,850.00 from Welch & Co., making the total received by it on account of the assessments made as of prior to the close of 1925, \$396,812.50. This was at a time when its total expenditures were only \$306,564.97. On January 19, 1926, it paid Oscar Sutro a fee of \$100,000.00, so that as of the date of the receipt of the last payment from any of the co-defendants, the total expenditure by American Factors was \$406,564.97, or less than \$10,000.00 more than the total paid in.

It is quite obvious that the statement of the Treasurer of the company (R. 256-257, 291) as to the method of determining the amounts to be assessed to the co-defendants is borne out by the record. It is clear that up to this time the co-defendants had paid in to taxpayer practically the full amount of the expenses paid.

It is also apparent that the assessments made against the co-defendants on a per share basis were made before the decision of the trial judge of the Superior Court of California on January 6, 1926. Once the case had been decided by the trial judge, the amount of the additional payments made for Hackfeld litigation expenses in the years prior to 1932 was not very large. No further assessments were made against the co-defendants thereafter. If the judgment of the trial Court did not stand up, there was time enough then to collect from its co-

defendants the amounts paid for said litigation expenses. The very fact that all of the expenses through 1925 and prior to the judgment by the trial Court were paid by the co-defendants militates very strongly against any finding or presumption that there was any apportionment between American Factors and the other co-defendants as to the shares of the expenses to be borne by each.

There is no evidence of and there was at no time any agreement as to the prorating of the litigation expenses as between American Factors on the one hand and the co-defendants on the other. The only agreement as to prorating was among the co-defendants themselves, so that if they were finally determined to be liable therefor, they would share the expenses pro rata on an original subscription per share basis. The question as to whether or not the co-defendants or American Factors would ultimately pay the expenses of litigation was not determined until after the final conclusion of the litigation (R. 205, 280-283, 289).

The sum of \$171,795.26 represents the portion of the Hackfeld litigation expense paid by American Factors upon the approval of the committee of the co-defendants after the final assessment among the members of the group on a per share basis was made and the amounts paid in.

The District Court, determining that all the expenditures, totalling \$568,607.76, accrued in 1932 and would be ordinary and necessary business expenses in 1932 had not a portion thereof been voluntarily paid



by the co-defendants, held that American Factors could deduct only the amount not paid in by others in the first instance, but could not deduct the amount so paid by others and voluntarily reimbursed by American Factors to such co-defendants without demand or test of their right to reimbursement and in the absence of a promise or implied intention to reimburse them at the time they made their contribution toward the expenses of the litigation.

With respect to the portion thereof, in the amount of \$83,802.76, paid prior to 1932, it is contended by counsel for Agnes M. Kanne that since this amount was paid prior to 1932 it is not possible to conclude that this amount accrued in 1932. In support thereof, the case of *Chestnut Securities Co. v. United States*, 62 F. Supp. 574, is cited. This case has no relation to the present issue. As between a debtor and creditor, the payment to the creditor may constitute such payment an accrual of the liability at the time of payment. Certainly, when a debtor discharges a debt by payment, the expense may have accrued as to the debtor. But here we are concerned with the question as to who the debtor is, that is, which of two persons will ultimately bear the liability for an amount already paid. Here is a case where liabilities were incurred and were paid, but the ultimate question as to whose liability those payments constituted was not and could not be settled until the final determination of the litigation which it is conceded occurred in 1932.

As set forth in the cases of *United States v. Anderson*, 269 U.S. 422, 70 L. ed. 347, and *Brown v. Helver-*



*ing*, 291 U.S. 193, 78 L. ed. 725, cited by counsel for Agnes M. Kanne (Br. p. 16), an expense accrues for deduction at the time the events occur which determine the liability of a taxpayer to pay and fix the amount. It is quite obvious that all the events did not and could not have occurred prior to 1932 which would determine whether the liability was that of American Factors or the other co-defendants. There is no question that one or the other must pay and, for convenience, American Factors acted as banker and did pay, but the determination of which was ultimately to be responsible therefor could not be fixed in any year prior to 1932, and that is the final event on the happening of which the liability accrued and became deductible.

With respect to the amount of \$87,992.50 paid in 1932, counsel for Agnes M. Kanne relies on the fact that no showing was made that the services were rendered in 1932 and the presumption is that they undoubtedly accrued in prior years. With respect to this amount, there is no difference between that and any other portion of the amount. It is not a question of when the services were rendered, or when the services were paid for, it is merely a question of when it could finally be determined which of the parties were liable for the payment therefor. Further, in any event, with respect to the fee of \$85,000.00 paid to Oscar Sutro on July 28, 1932, it must be apparent that the expense therefor did not accrue until the amount thereof was fixed and the bill was submitted, and it is submitted that in no event can this amount be disallowed as a deduction in 1932.

(B) THE DISTRICT COURT ERRED IN DISALLOWING THE DEDUCTION AS AN ORDINARY BUSINESS EXPENSE IN 1932, BY AMERICAN FACTORS, LIMITED, OF \$396,812.50 OF HACKFELD LITIGATION EXPENSES REIMBURSED TO OTHER DEFENDANTS.

As pointed out above, the entire argument of counsel for Agnes M. Kanne in regard to the deductibility of the Hackfeld litigation expense is based on the erroneous assumption that the costs of litigation were apportioned or prorated between American Factors, Limited, on one hand and the co-defendants on the other. This erroneous assumption has colored all the arguments presented so that the cases presented, when applied to the real facts, sustain the contentions of taxpayer.

(a) The amount was paid or incurred in carrying on the taxpayer's business.

The Hackfeld litigation had to do with charges and claims against the taxpayer, which charges were based primarily upon charges of fraud and conspiracy alleged against the taxpayer and the co-defendants acting for and on behalf of the corporation. It would have been impossible for the corporation to defend itself against the charges and the claims against it without establishing the innocence of the other co-defendants who were the officers and agents of the corporation whose alleged misconduct had to be established in order to sustain the claim against the corporation and with whom the corporation was alleged to have conspired. Therefore, the expenditures made by the corporation in defense of these claims were on its own behalf and were directly connected with its trade and

business. This the Court found, as evidenced by the statement from its opinion hereinabove cited, that such expenses would have been deductible if the co-defendants had not voluntarily paid them in the first instance. Accordingly, on this point, it must be held that the amount so paid was incurred in carrying on the taxpayer's business.

In *Hales-Mullaly, Inc. v. Commissioner*, 131 F. (2d) 509, as pointed out in the footnote on page 22 of the brief for Agnes M. Kanne, the taxpayer's liability arose solely from its receiving and retaining the benefits of the fraud of the individuals who organized it, while in the present case damages were also claimed against the corporate taxpayer as a result of its mismanagement after its organization and while engaged in business of the business and assets acquired from Hackfeld. This would suffice to show that that case is not in point here.

This all-important distinction is sought to be avoided by reliance on the fact that here the total expenses of the litigation were apportioned between the stockholder-incorporators and the taxpayer. As we have pointed out before, this is not true.

The case of *Blackwell Oil & Gas Co. v. Commissioner*, 60 F. (2d) 257 (C.A. 10th), cited on page 22 of the brief for Agnes M. Kanne, involved the deductibility by a corporation of litigation costs and amounts paid in settlement of two suits, one of which was against the corporation to recover possession of titles to certain lands as well as for profits and damages for waste. With regard to the deductibility of the amount

paid in compromise of the action against the corporation, the Court held that the action was in defense of title and, to such extent, the expenditures therefor could not be deducted, but constituted a capital expenditure. In the present case it must be remembered that the complaint in the Hackfeld litigation affirmed the acquisition of the assets of Hackfeld & Company by American Factors, Limited, and the suit was merely one for damages. The other action in the *Blackwell* case, *supra*, was against directors and principal stockholders of the corporation alleging an unlawful conspiracy among them. The corporation was not a defendant. As pointed out in the brief for American Factors, Limited (pp. 40-41), the Court, in denying the deductibility by the corporation of the amounts paid in settlement, held that since the gist of the action was unlawful conspiracy the corporation was not liable for the payments in settlement.

The case of *Knight-Campbell Music Co. v. Commissioner*, 155 F. (2d) 837 (C.A. 10th), cited on page 22 of brief for Agnes M. Kanne, involved the deductibility of attorneys' fees paid by the corporation to attorneys for common stockholders arising out of a suit between the preferred and common stockholders which was settled. The only way in which the corporation was involved was that receivership proceedings were initiated by the preferred stockholders to enforce the judgment against the common stockholders. Certainly the facts are in no way helpful to the determination of the present case.

*White v. Commissioner*, 61 F. (2d) 726 (C.A. 9th), cited on page 22 of brief for Agnes M. Kanne, denied



deduction by a partnership of payment in settlement of debt of a partner not connected with or growing out of the business of the partnership which it was claimed was necessary to protect creditors of the firm and to free the partnership of anxiety so he could devote himself to his duties in the partnership.

*A. Giurlani & Bro. v. Commissioner*, 119 F. (2d) 852 (C.A. 9th), cited on page 22 of brief for Agnes M. Kanne, denied deduction for the amount paid to the creditors of another corporation which controlled the source of supply of taxpayer's most profitable line of merchandise, which amount was paid to save said corporation from bankruptcy and preserve the source of supply of the taxpayer.

*Pantages Theatre Co. v. Welch*, 71 F. (2d) 68 (C.A. 9th), cited on page 22 of brief for Agnes M. Kanne, denied deduction for defense of taxpayer's President and Manager from charge of rape.

*Robinson v. Commissioner*, 53 F. (2d) 810 (C.A. 8th), cited on page 22 of brief for Agnes M. Kanne, denies deduction for payment of taxes on leased property where lease did not impose any obligation upon taxpayer to pay the property taxes.

*Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 87 L. ed. 1607, cited on page 22 of brief for Agnes M. Kanne, denied deduction for operating deficit of a subsidiary corporation organized to do business taxpayer was not empowered to do.

*South American Gold & Platinum Co. v. Commissioner*, 8 T.C. 1297, cited on page 22 of brief for Agnes M. Kanne, likewise denied deduction for payment for



legal services for settlement of dispute and claims of a subsidiary corporation.

All of these cases are ones in which the claimed deductions are not closely related to the business of a taxpayer. These cases are cited to support a contention based upon the erroneous assumption of the fact that American Factors, Limited, agreed that the co-defendants would pay a part of the expenses and, therefore, when American Factors, Limited, afterwards reimbursed the co-defendants, it was paying amounts it was not obligated to pay, but was merely volunteering to pay the liabilities of the co-defendants.

Clearly, if American Factors, Limited, had paid all the expenses in the first instance, it could not have been denied the deduction of \$396,812.50 on the ground that the expenditure was not paid or incurred in carrying on its business.

**(b) The expenses were ordinary and necessary.**

Again, counsel for Agnes M. Kanne, in arguing that the expenses in question were not ordinary and necessary, is assuming that \$396,812.50 of the litigation expenses were agreed to be paid by the co-defendants as their share of the expenses incurred. Having assumed that it was their liability, counsel then goes on to assume that the payment to the co-defendants by American Factors, Limited, of that amount is, in effect, the payment of the liabilities of others. In support of the contention that the liabilities discharged by taxpayer were the liabilities of others, *Matson Navigation Co. v. Commissioner*, 24 B.T.A. 14, is cited in a footnote on page 25 of brief for Agnes

M. Kanne. An examination of that case will show that the facts before the Board of Tax Appeals were different than the facts presented here. There the Court states that Matson Navigation Co., having agreed to prorate the expenses of the Hackfeld litigation, received and paid statements of its proportionate share to American Factors, Limited, which, in turn, paid the accounts rendered to it on account of counsel fees and litigation expenses.

“American Factors, Ltd., as a corporation, paid no part of the expense \* \* \* Petitioner has not been reimbursed in any way or in any amount on account of the \$40,250.00 so expended” (at p. 17).

Whether the Court would have determined that the amount paid should be allowed to Matson Navigation Co. as a deduction if the fact were established, as here, that American Factors, Limited, did reimburse the amounts paid by Matson Navigation Co. as well as the others, is an open question. Certainly this case can have no bearing on determining whether American Factors could reimburse Matson Navigation Co. and the other defendants and be entitled to a deduction therefor.

None of the cases cited by counsel (Br. for Agnes M. Kanne, p. 25) are cases similar to the case here. Once it is assumed that the obligation is another's, it may follow that the payment of such liabilities of another is not generally an ordinary and necessary business expense. But none of the cases cited help to determine whether the ultimate obligation to pay the \$396,812.50 was that of American Factors, Limited, or of the co-defendants.

The expenses were incurred for the entire litigation, not \$396,812.50 to defend tortious acts of promoters or organizers of the corporation on one hand, and \$171,795.26 to defend the corporation itself for its unlawful conspiracy and mismanagement on the other, as appears to be the argument in the brief for Agnes M. Kanne on pages 25-27. As pointed out above, the litigation expenses of defendants, both stockholder-incorporators and taxpayer, were not allocated between them in a manner not challenged as unfair or incorrect, as there alleged.

As pointed out in the brief for American Factors, Limited (pp. 39-41), the co-defendants did not voluntarily pay the expenses of litigation without expectation of reimbursement in the event that they were freed of charges of fraud and conspiracy upon the final determination of the litigation. Rather, the amounts were prorated among the co-defendants so that all would bear a fair share in the event the judgment had been against them and they were themselves liable for the expenses of litigation.

**(c) The expenses did accrue as a deduction in 1932.**

As pointed out in the brief for American Factors, Limited (pp. 41-51), once the litigation charging the co-defendants with fraud and conspiracy had been finally concluded holding that they were not guilty of any fraud or conspiracy, American Factors, Limited, for the first time became bound to pay the litigation expenses and to reimburse the co-defendants for the portion of the expenses paid by them amounting to \$396,812.50.

The conclusion of law of the District Court (R. 101), cited on page 27 of the brief for Agnes M. Kanne, “\* \* \* that the amount was not an ordinary and necessary expense paid or *incurred during the taxable year 1932* by plaintiff in carrying on its business,” appears to have been italicized by counsel in the wrong manner. We believe the words to be italicized are “by plaintiff”. This is supported by the portion of the opinion hereinabove quoted disallowing the portion of the litigation expenses paid to American Factors, Limited, for that purpose by the other defendants (R. 64).

We believe that the court erred in not allowing the amounts originally paid in by the other defendants to American Factors, Limited, as well as the balance of the expenses, for the reasons set forth hereinabove and in the brief for American Factors, Limited.

It is respectfully submitted, therefore, that the taxpayer is entitled to deduct the amount of \$396,812.50, reimbursed by it to the co-defendants in 1932, in addition to the amount allowed it as a deduction in the judgment of the Court below.

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## II.

**THE DISTRICT COURT ERRED IN DISALLOWING AMERICAN FACTORS THE DEDUCTION OF THE PAYMENT OF \$50,000.00 TO WATERHOUSE COMPANY IN 1931.**

With regard to the deductibility of the sum of \$50,000.00 paid to Waterhouse Company in 1931, counsel for Agnes M. Kanne contend that said amount



is not deductible as a bad debt in 1932. The argument is that the note received by taxpayer was not payable at all events, but its payment was contingent on Waterhouse Company having funds to pay it after all its other liabilities and expenses had been paid. This fact, together with the fact contended for by counsel that the amount was paid as a contribution to serve the community generally and without expectation of repayment, it is said, requires the conclusion that no debt sufficient to support a deduction was created. Further, it is argued that even if a valid debt was created, the taxpayer has failed to prove facts sufficient to enable the District Court to determine whether the taxpayer's alleged ascertainment of the worthlessness of the debt in 1932 was based on facts warranting that conclusion.

It is also contended that said sum is not deductible as a loss in 1932 because a voluntary contribution is not a basis for deducting a loss at any time and, in any event, if there was a loss, it was not sustained in 1932.

In addition, it is contended that the \$50,000.00 is not deductible as an ordinary and necessary business expense and, even if it were, it accrued in 1931 when it was paid and could not be deducted in 1932.

All of these matters are covered in the brief for American Factors, Limited (pp. 51-75).



(A) THE PAYMENT OF \$50,000.00 DID CREATE  
A VALID DEBT.

Counsel for Agnes M. Kanne contend (Br. pp. 29-32) that the payment to Henry Waterhouse Trust Company did not constitute a valid debt because it was a conditional obligation and contingent as to payment. It is true that the note was repayable only out of a particular fund after other liabilities had been settled therefrom. But it still was an absolute undertaking to pay if funds remained for payment. Every note or debt is subject, with respect to payment, to the condition or contingency that the obligors have funds with which to pay. Also, we doubt that anyone would seriously challenge the validity of a second mortgage as a valid debt because it is repayable only after satisfying the prior mortgage. Merely to state the proposition argued for by counsel for Agnes M. Kanne seems to us to make apparent its fallacy.

Counsel seem to have missed, or are attempting to slide over the relevant portion of *Clay Drilling Co. v. Commissioner*, 6 T.C. 324, when it is referred to (in footnote, p. 31 of their brief) as a case having to do with whether a debt was cancelled and forgiven as a result of an agreement under which the note became payable only in the manner agreed on. The real point of the case is that the Court there held that even though the debt was, from the date of the agreement on, payable only out of commissions that might or might not be earned in the future, nevertheless it still continued to be a valid debt which could be the subject of a bad debt deduction. This was held to be so even though payable only in a special way and not

out of the debtor's general funds. The holding of the Court would have been the same even if the note, at the time it was first issued, had been payable in the manner provided in the subsequent agreement.

The case of *Western Woodwork & Lumber Co. v. Commissioner*, 6 T.C.M. 504, conceded by counsel for Agnes M. Kanne (footnote, p. 31) to hold that a note represented a debt despite the contingent nature of its payment, is not contrary to the authorities cited by counsel, as they state, nor is it incorrect.

As stated by the Tax Court in the *Clay Drilling Co.* case, *supra*, (quoted in Br. for American Factors, p. 63):

“\* \* \* We know of no law which is to the effect that a debt is canceled and forgiven merely because the manner of its payment is restricted and it is agreed that the debtor shall not be personally liable if the debt is not fully paid in that manner. Both parties concede that they know of no case exactly in point. Our search has not disclosed any.”

We have no quarrel with the propositions of law stated that the allowance of a bad debt presupposes the existence of a valid debt arising out of a debtor-creditor relationship, and that the giving of a note or other evidence of indebtedness which may be legally enforceable is not of itself conclusive of the existence of a bona fide debt. However, we do disagree as to what kind of condition prevents an obligation from being a debt which can be the subject of a deduction. How much of a condition must there be before the obligation ceases to be a debt? Suppose it is not pay-

able for a number of years—say 5 or 10—does such condition prevent it from being a debt. Suppose its maturity date is 1000 years? Or 100, or 50, or 25? At what point does the condition cause it to fail to be a debt? Suppose it is only payable out of the proceeds of real property, or personal property, or from a special bank account, or securities deposited for liquidation. Obviously it cannot be every condition that renders an obligation not a debt. The cases cited by counsel (Br. pp. 30-31) are quite different from the case here and do not support the proposition argued for.

*Shiman v. Commissioner*, 60 F. (2d) 65 (C.A. 2nd), cited by counsel for the proposition that a conditional obligation does not give rise to a debt, has this to say about it:

“\* \* \* It has indeed been at times debated whether a conditional obligation is an obligation at all until the condition is fulfilled, but the debate is scholastic” (at p. 66).

*Milton Bradley Co. v. U. S.*, 146 F. (2d) 541 (C.A. 1st) involved a unique claim for a bad debt deduction. There it was claimed that the amount of an overpayment of federal taxes, for which timely claim for refund, as required by the statute, had not been filed, was deductible as a bad debt at the time the period for expiration of claims for refund expired.

*S. Naitove & Co. v. Commissioner*, 32 F. (2d) 949 (C.A. D.C.) has no possible application to the principle for which it is cited, having to do with time of accrual of expenses.

*Wolff v. Commissioner*, 26 B.T.A. 622, was determined primarily on the basis that the advances to taxpayer's son and nephew for the purpose of facilitating the liquidation of the nephew's partnership business were gifts, not loans. There a rebuttable presumption existed because of the relationship which was not overcome by evidence of intent to treat the advance as a loan. There, also, the Court considered that there were several contingencies to be overcome before the obligation, if any there was in that case, was to be paid. A partnership had to be liquidated, leaving sufficient assets to pay all other creditors and petitioner, a doubtful British claim had to be successfully prosecuted and the partnership had to be advantageously and expeditiously liquidated.

There are many more conditions there, including one entirely dependent on the will of the debtor, namely, the expeditious settlement of the affairs of the partnership which must precede the payment due on the note.

The case of *J. S. Cullinan v. Commissioner*, 19 B.T.A. 930, cited in the *Milton Bradley Co.* case, *supra* (Br. for Agnes M. Kanne, p. 30), related to a claim for deduction of approximately \$30,000.00. The campaign committee of a candidate for the United States Senate was seeking thirty men to contribute \$5,000.00 each for campaign expenses. The petitioner contributed \$5,000.00 and agreed to advance to the committee \$30,000.00, believing it would be repaid out of other contributions to the campaign fund. Only a small part was obtained and returned to petitioner. The balance claimed as a bad debt was disallowed.



*Eckert v. Burnet*, 283 U.S. 138, 75 L.ed. 911, involved a claim for a bad debt deducted by a taxpayer on the cash basis. Petitioner and his partner were joint endorsers of notes issued by a corporation they had formed. The corporation being unable to pay, the petitioner and his partner made a settlement of their liability by giving a note to the bank and receiving the corporation's note. Each claimed the right to deduct one-half of the amount of the note given. The Court held petitioner merely exchanged his note, under which he was primarily liable, for the corporation's note on which he was secondarily liable, without any outlay of cash. No deduction was held allowable until he ultimately paid the note.

It is difficult to see how this case is applicable.

*Howell v. Commissioner*, 69 F. (2d) 447 (C.A. 8th), merely held that in the absence of agreement, one who indemnifies a creditor against loss from a debtor's nonperformance of an obligation does not, by payment of indemnity, acquire any remedy over against the debtor, accordingly, no debtor-creditor relationship existed.

Again, it is difficult to see the applicability of this case.

*American Cigar Co. v. Commissioner*, 66 F. (2d) 425 (C.A. 2nd), involved the deductibility of an advance made to a related company at the time taxpayer knew it could never be repaid.

*In re Parks Est.*, 58 F. (2d) 965 (C.A. 2nd), involved a claim for a bad debt on account of amounts



put into bank by the president to prevent closing thereof because of treasurer's defalcations. The treasurer assigned options on coal lands and the bank assigned claims against overdrafts of depositors, but these were worthless at the time. The Court did not pass on whether these represented debts or not, but held that if they were, they did not decrease in value after the taxpayer got them and there was nothing to charge off.

These cases, to the extent that they are at all applicable, would illustrate that where the contingency as to payment is sufficient so that the probability is great that they were not intended to be paid at all, or that they certainly would not be paid, the obligation is not recognized as a debt.

The expectation of repayment existed at the time the note here in question was received, and it was based upon a reasonable examination of all the pertinent facts. This is sufficient to make the note evidence of an absolute debt, although its payment may have been deferred until after payment of other obligations out of a particular pool of assets.

There is also no disagreement with the statement that advances voluntarily made without expectation of repayment do not create a debt which can provide the basis for a bad debt deduction.

However, it is submitted, as pointed out in the brief for American Factors, Limited (pp. 58-61), that the only evidence is that there was a definite expectation that the loan would be repaid.

It should also be pointed out that we do not concede, as erroneously stated by counsel (p. 33), that the motive for advancing the money was the protection of the commercial community. Nor did the Court hold that that was the sole motive for making the loan. In any event, as pointed out (Br. p. 66), the motive would be unimportant in determining whether the payment is or is not a loan which can be the subject of a tax deduction as a bad debt.

**(B) THE DEBT WAS ASCERTAINED TO BE  
WORTHLESS IN 1932.**

As pointed out in the brief (pp. 67-68), the direct evidence of witnesses Lowrey, Linden and Castle, and the Bank Examiner's report as of December 31, 1932, are relied on to sustain the reasonableness of the ascertainment of worthlessness and the charge-off of the note in 1932. Such evidence represents the accumulated views of the persons who were charged with the duty of knowing the facts and who were in a position to find them out. Alfred Castle and Sherwood Lowrey were both members of the advisory committee which represented the noteholders and were in close touch with the liquidation of assets of Henry Waterhouse Trust Company, being consulted with respect to all important matters in connection therewith (R. 449-450, Pet.'s Exh. P-11, pp. 389-390).

With regard to the failure of the taxpayer to concede the worthlessness of the claim, as suggested by Waterhouse in 1932 (Br. for Agnes M. Kanne, p. 37), we cannot see how that would affect the matter. It is not necessary for a creditor to return to a debtor for

cancellation a note he holds against him to be enabled to charge the same off and claim deduction therefor. He may still retain his right to receive payments that only a most unusual change in circumstances might make possible.

(C) IF NOT DEDUCTIBLE AS A BAD DEBT, THE SUM OF \$50,000.00, REPRESENTING THE AMOUNT PAID TO WATERHOUSE COMPANY IN 1931, WAS DEDUCTIBLE IN 1932 AS A LOSS SUSTAINED OR AS AN ORDINARY AND NECESSARY BUSINESS EXPENSE OF AMERICAN FACTORS.

It is difficult to see how the cases of *Commissioner v. Gilt Edge Textile Corp.*, 173 F. (2d) 801 (C.A. 3rd), and *Uhl Estate Co. v. Commissioner*, 116 F. (2d) 403 (C.A. 9th), support the contention of counsel (Br. p. 38) that the loss, if any, is deductible in 1931, or, as they contend, it is not deductible at all. Further, the identifiable events occurring in 1932 which fixed the loss in that year are the separate determinations in that year that the note evidencing the payment to Waterhouse Company, given in the course of the business of taxpayer, was uncollectible.

The finding by the District Court that because a balance of \$190,457.35 still remained in the reserve for losses, against which further losses must be charged before there would be any impairment for the repayment of the \$400,000.00 of contributions to the noteholders, there could be no loss to the noteholders in 1932, cited by counsel (Br. p. 38), is erroneous. Only the actual losses finally sustained had been charged against the reserve for losses. However, as pointed out in the Bank Examiner's report (R. pp. 553-560), a reappraisal of the assets required the setting up of

an additional reserve for losses which completely wiped out the equity of the noteholders, and indicated an additional loss by the guarantor, Bishop Trust Company, Limited.

With regard to the facts found by the Board of Tax Appeals (now The Tax Court) in *Bishop Trust Co. v. Commissioner*, 36 B.T.A. 1173, and *Bishop Trust Co. v. Commissioner*, 47 B.T.A. 737, such facts as relate to the contributions by the noteholders to Henry Waterhouse Trust Company, the reasons therefor, and the circumstances under which the loans were made, the economic condition of the Territory at the time, are all matters of which the Court may take judicial notice, as pointed out in the opening brief.

It is respectfully submitted that the District Court erred in not allowing the deduction of \$50,000.00 paid to Waterhouse Trust Company as a deduction as a bad debt, as a loss sustained, or as an ordinary and necessary business expense in the year 1932.

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### CONCLUSION.

It is therefore respectfully submitted that American Factors, Limited, is entitled to the deduction of the amount of \$396,812.50 of Hackfeld litigation expenses reimbursed to the co-defendants as an ordinary and necessary expense in computing its taxable net income for the calendar year 1932, in addition to \$171,795.26 which has been allowed as a deduction by the District Court; and that American Factors, Limited, is entitled to deduct the amount of \$50,000.00 advanced to Water-

house Company, which became uncollectible in 1932, as a bad debt, as a loss sustained in that year, or as an ordinary and necessary expense of doing business in that year.

Dated, Honolulu, T. H.,  
June 9, 1950.

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*American Factors, Limited.*

SMITH, WILD, BEEBE & CADES,  
*Of Counsel.*



**In the United States Court of Appeals  
for the Ninth Circuit**

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AGNES M. KANNE, EXECUTRIX UNDER THE WILL AND OF  
THE ESTATE OF FRED H. KANNE, COLLECTOR OF  
INTERNAL REVENUE OF THE UNITED STATES FOR THE  
DISTRICT OF HAWAII, APPELLANT

v.

AMERICAN FACTORS, LIMITED, AN HAWAIIAN CORPORA-  
TION, APPELLEE

---

AMERICAN FACTORS, LIMITED, AN HAWAIIAN CORPORA-  
TION, APPELLANT

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DISTRICT OF HAWAII, APPELLEE

---

ON APPEALS FROM THE UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF HAWAII

---

REPLY BRIEF FOR AGNES M. KANNE

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**In the United States Court of Appeals  
for the Ninth Circuit**

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No. 12391

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---

*ON APPEALS FROM THE UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF HAWAII*

---

**REPLY BRIEF FOR AGNES M. KANNE**

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**I**

A. Taxpayer's counsel are mistaken in their assertion that the argument of counsel for Agnes M. Kanne in regard to the deductibility of the Hackfeld litiga-

tion expense is based on the erroneous assumption that the costs of litigation were apportioned or prorated between the taxpayer on the one hand and the co-defendants on the other hand. (Answering Br. 6.)

We did indeed refer to the sum of \$171,795.26 as the taxpayer's share of these expenses, but our identification of that portion of the expenses as the taxpayer's share was not based on any rash or erroneous assumption. It was based on the undisputed fact that the taxpayer paid that much of the total litigation expenses out of its own funds and did not ask or expect to be reimbursed therefor by its co-defendants. (R. 77-79, 198.) The \$396,812.50 which the taxpayer refunded to its co-defendants in 1932 represented that portion of the total litigation expenses which the taxpayer's co-defendants offered to pay and did pay to the extent of the assessments against them and was contributed by them in 1924, 1925, and 1926 and was paid in years prior to 1932. (R. 78-79, 198-201.)

Thus, we are at a loss to understand the assertion by taxpayer's counsel, particularly in view of their later declaration that the taxpayer, acting as banker for the committee, paid bills approved by it, and, when a certain amount of expenses *had been incurred*, an assessment would be levied, divided by the number of shares, and collections would be made from each of the co-defendants on a per share assessment basis. (Answering Br. 7-9.)

It makes no difference that there was no prior agreement between the taxpayer and its co-defendants to prorate the litigation expenses between the taxpayer and its co-defendants. Notwithstanding the absence of such an agreement, the evidence indisputably shows that the expenses were actually apportioned between all the defendants and that the taxpayer received from

its co-defendants on account of the assessments made against them a total of \$396,812.50. (R. 256-257, 291; Answering Br. 7-8.) Counsel's arguments to the contrary are specious and tend to confuse the real factual situation.

Viewing counsel's arguments objectively, it seems their purpose is to convey to this Court (we think erroneously) that without a prior agreement for the apportionment of these expenses between the taxpayer on the one hand and its co-defendants on the other hand, it could not be determined whether the taxpayer and/or its co-defendants were liable for these expenses until after the Hackfeld litigation was concluded in 1932. But liability for the expenses was incurred prior to 1932, and that liability was discharged in 1924, 1925-1926, 1927, 1928, 1929, and 1931. (R. 198-200.) It will be noted from the excerpt quoted below from the Court of Claims opinion in *Chestnut Securities Co. v. United States*, 62 F. Supp. 575, that it is unimportant that this liability may not have arisen as the result of a debtor-creditor relationship. The Court of Claims in the *Chestnut Securities Co.* case said (p. 576):

One is not entitled to accrue a debt or other liability which is asserted against him but which he disputes and litigates, until the litigation is concluded. But if a liability is asserted against him and he pays it, though under protest, and though he promptly begins litigation to get the money back, the status of the liability is that it has been discharged by payment. It is hardly conceivable that a liability asserted against him, which he has discharged by payment, has not yet "accrued" within the meaning of the tax laws and the terminology of accounting. Accrual, from the debtor's standpoint, precedes payment, and does not survive it. (Emphasis supplied.)



tion expense is based on the erroneous assumption that the costs of litigation were apportioned or prorated between the taxpayer on the one hand and the co-defendants on the other hand. (Answering Br. 6.)

We did indeed refer to the sum of \$171,795.26 as the taxpayer's share of these expenses, but our identification of that portion of the expenses as the taxpayer's share was not based on any rash or erroneous assumption. It was based on the undisputed fact that the taxpayer paid that much of the total litigation expenses out of its own funds and did not ask or expect to be reimbursed therefor by its co-defendants. (R. 77-79, 198.) The \$396,812.50 which the taxpayer refunded to its co-defendants in 1932 represented that portion of the total litigation expenses which the taxpayer's co-defendants offered to pay and did pay to the extent of the assessments against them and was contributed by them in 1924, 1925, and 1926 and was paid in years prior to 1932. (R. 78-79, 198-201.)

Thus, we are at a loss to understand the assertion by taxpayer's counsel, particularly in view of their later declaration that the taxpayer, acting as banker for the committee, paid bills approved by it, and, when a certain amount of expenses *had been incurred*, an assessment would be levied, divided by the number of shares, and collections would be made from each of the co-defendants on a per share assessment basis. (Answering Br. 7-9.)

It makes no difference that there was no prior agreement between the taxpayer and its co-defendants to prorate the litigation expenses between the taxpayer and its co-defendants. Notwithstanding the absence of such an agreement, the evidence indisputably shows that the expenses were actually apportioned between all the defendants and that the taxpayer received from

its co-defendants on account of the assessments made against them a total of \$396,812.50. (R. 256-257, 291; Answering Br. 7-8.) Counsel's arguments to the contrary are specious and tend to confuse the real factual situation.

Viewing counsel's arguments objectively, it seems their purpose is to convey to this Court (we think erroneously) that without a prior agreement for the apportionment of these expenses between the taxpayer on the one hand and its co-defendants on the other hand, it could not be determined whether the taxpayer and/or its co-defendants were liable for these expenses until after the Hackfeld litigation was concluded in 1932. But liability for the expenses was incurred prior to 1932, and that liability was discharged in 1924, 1925-1926, 1927, 1928, 1929, and 1931. (R. 198-200.) It will be noted from the excerpt quoted below from the Court of Claims opinion in *Chestnut Securities Co. v. United States*, 62 F. Supp. 575, that it is unimportant that this liability may not have arisen as the result of a debtor-creditor relationship. The Court of Claims in the *Chestnut Securities Co.* case said (p. 576):

One is not entitled to accrue a debt or other liability which is asserted against him but which he disputes and litigates, until the litigation is concluded. But if a liability is asserted against him and he pays it, though under protest, and though he promptly begins litigation to get the money back, the status of the liability is that it has been discharged by payment. It is hardly conceivable that a liability asserted against him, which he has discharged by payment, has not yet "accrued" within the meaning of the tax laws and the terminology of accounting. Accrual, from the debtor's standpoint, precedes payment, and does not survive it. (Emphasis supplied.)

Thus, contrary to the bland assertion of taxpayer's counsel (Answering Br. 10), we think the above case is particularly apposite to the present issue.

B. We also think the case of *Knight-Campbell Music Co. v. Commissioner*, 155 F. 2d 837 (C.A. 10th), cited on page 22 of brief for Agnes M. Kanne, clearly supports our position on the present issue. That corporation had obtained judgments in its favor for the benefit of a majority of its preferred stockholders against the directors who were common stockholders, and receivers were appointed to operate the business. Pending appeal from the judgments, two of the directors retained attorneys to terminate the receivership and to resist the receivers' application for authority to liquidate the corporation's business. During the hearing on the receivers' application, settlement was reached providing for retirement of the preferred stock and for continuance of the business; the corporation assigned to one of the directors the judgments which were thereupon cancelled. Later the corporation reimbursed the directors for fees which they had paid to their attorneys, and the corporation claimed a deduction in its income tax return for 1942 for the amount of those attorneys' fees. The Commissioner of Internal Revenue disallowed the deduction, the Tax Court sustained the Commissioner, and the Court of Appeals affirmed. The Court of Appeals said (p. 840):

A liability voluntarily assumed or paid by a corporate taxpayer as reimbursement of two of its stockholders for sums which they paid to attorneys as a fee for services rendered primarily in behalf of certain stockholders in securing cancellation of personal judgments which the taxpayer held against such stockholders is not an ordinary and necessary expense in carrying on

the trade or business of the taxpayer, within the meaning of section 23, *supra*.

The above case and those cited on page 22 of the brief for Agnes M. Kanne were cited, of course, to sustain our position that the District Court was correct in its finding that repayment of the \$396,812.50 by the taxpayer to its co-defendants was wholly voluntary. (R. 77-78.) Our position in this respect was not based upon any assumption that the taxpayers had agreed that its co-defendants would pay a part of the expenses, as counsel for the taxpayer mistakenly assert. (Answering Br. 16.) Whether or not the taxpayer would be entitled to a deduction for \$396,812.50 if it had paid all the expenses in the first instance is not before this Court for decision. We are concerned here with the correctness of the finding of the District Court that the taxpayer in 1932 voluntarily repaid to its co-defendants the above sum which they incurred and paid prior to 1932 as their share of the litigation expense. (R. 77-78.)

For the foregoing reasons and all those discussed in Point II of our main brief, we submit the District Court's judgment in denying the deduction of \$396,812.50 in 1932 was correct, and should be affirmed.

## II

The situation respecting the \$50,000 contribution to the Henry Waterhouse Trust Company is not comparable to a second mortgage transaction. A mortgagor of a second mortgage is in fact a debtor because he has actually borrowed the money secured by the mortgage. At the time he borrows the money from the mortgagee, an appraisal of the fair market value of the property securing the loan presumably discloses



a value high enough not only to discharge the first mortgage but the second one too. The only contingency involved is the inherent risk in all such transactions that subsequent events might so depress the market for the property that the entire amounts of the loans could not be realized upon foreclosure sale of the property. But in the instant case the serious financial predicament (insolvency) of the Henry Waterhouse Trust Company was known when the contributions to the fund to help it meet the emergency were made, and they were made to prevent the disastrous effect its failure would have on the community and without expectation of repayment. (R. 60-61, 96, 102-103.) If the amounts paid into the Henry Waterhouse Trust Company fund were truly loans perhaps the motives which activated these payments might not be determinative of the deductibility thereof. But the motives which induced the taxpayer and the other contributors to make payments into that fund in 1931 certainly may be inquired into to ascertain whether they truly intended to loan the money or merely contribute it without expectation of repayment. As we pointed out in our main brief (pp. 32-33), the finding of the District Court that the taxpayer's payment of \$50,000 was merely a contribution without expectation of repayment is supported by the entire record. The taxpayer has failed to point to any evidentiary facts from which this Court may properly conclude that the lower court's finding in this respect was clearly erroneous. So that court's finding must stand.

A. There is, of course, no authority for recognizing a reserve for losses which is set up as the result of a reappraisal of assets as a sufficient basis for the ascertainment of the uncollectibility of an indebted-



ness. The value of assets fluctuates with changing conditions and an accountant's notion of what amount, if any, should be set up as a reserve for *unrealized* losses based on such an appraisal may be good accounting but it does not satisfy the statutory requirements of Section 23(k) of the Internal Revenue Code, which contemplates an ascertainment based on the happening of some event and the occurrence of actual facts then a reality. At any rate, the District Court found as a fact that there was at the end of 1932 a balance of \$190,457.35 remaining in the reserve for losses against which future losses must be charged before there would be any impairment for the repayment of the \$400,000 contributions to the special noteholders. That balance in the reserve was what was left after there had been charged against the reserve actual losses sustained. (R. 95.)

As pointed out at the trial by counsel for Agnes M. Kanne, the bank examiner's report to which taxpayer's counsel refer (Answering Br. 28-29) relates to an examination which was conducted during the year 1933 and is dated July 20, 1933, after the taxpayer had written off the \$50,000 as a bad debt. Although the trial judge refused to strike that report from the record, he said he would keep in mind that this report was made in 1933 after the former transactions of writing off the bad debt. (R. 562-563.) So, it certainly cannot be denied that, as the taxpayer did not have before it in 1932 the bank examiner's report dated July 20, 1933, that report had nothing whatsoever to do with the taxpayer's writing off the \$50,000 as a bad debt in 1932. Accordingly, as taxpayer's counsel have failed to show wherein the facts as found by the District Court (R. 91-96) are clearly erroneous, they must

stand. It follows that the District Court's conclusions of law concerning the non-deductibility of the \$50,000 should be affirmed.

Respectfully submitted,

THERON LAMAR CAUDLE,  
*Assistant Attorney General.*  
ELLIS N. SLACK,  
LELAND T. ATHERTON,  
*Special Assistants to the  
Attorney General.*

RAY J. O'BRIEN,  
*United States Attorney.*

JULY, 1950.

No. 12394

---

United States  
Court of Appeals  
for the Ninth Circuit.

---

MYRTLE CANON,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

---

Transcript of Record

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Appeal from the United States District Court,  
Northern District of California,  
Southern Division.

FILED

APR 6 1950

PAUL P. O'BRIEN,  
CLERK



No. 12394

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United States  
Court of Appeals  
for the Ninth Circuit.

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MYRTLE CANON,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

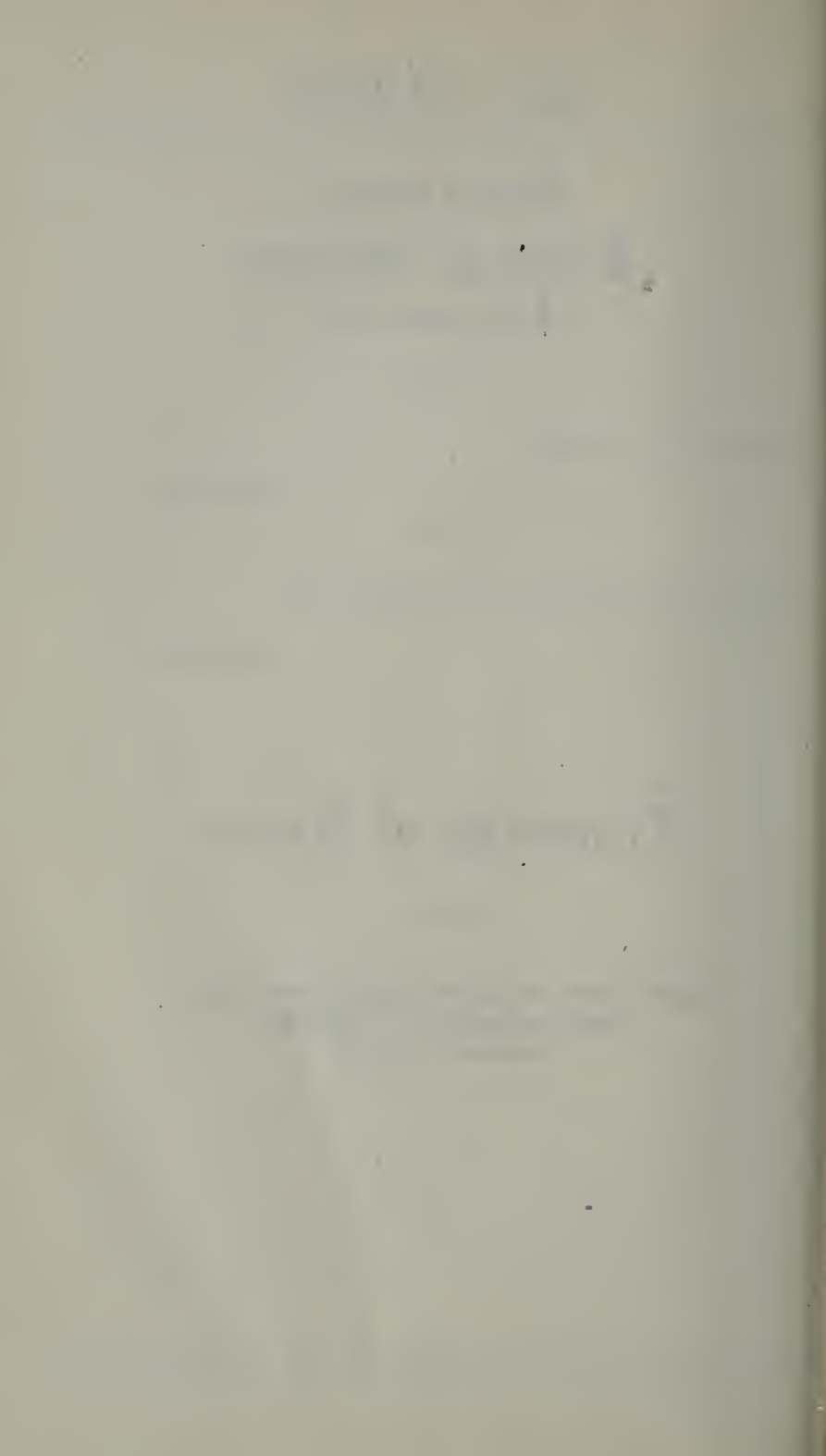
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Transcript of Record

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Appeal from the United States District Court,  
Northern District of California,  
Southern Division.





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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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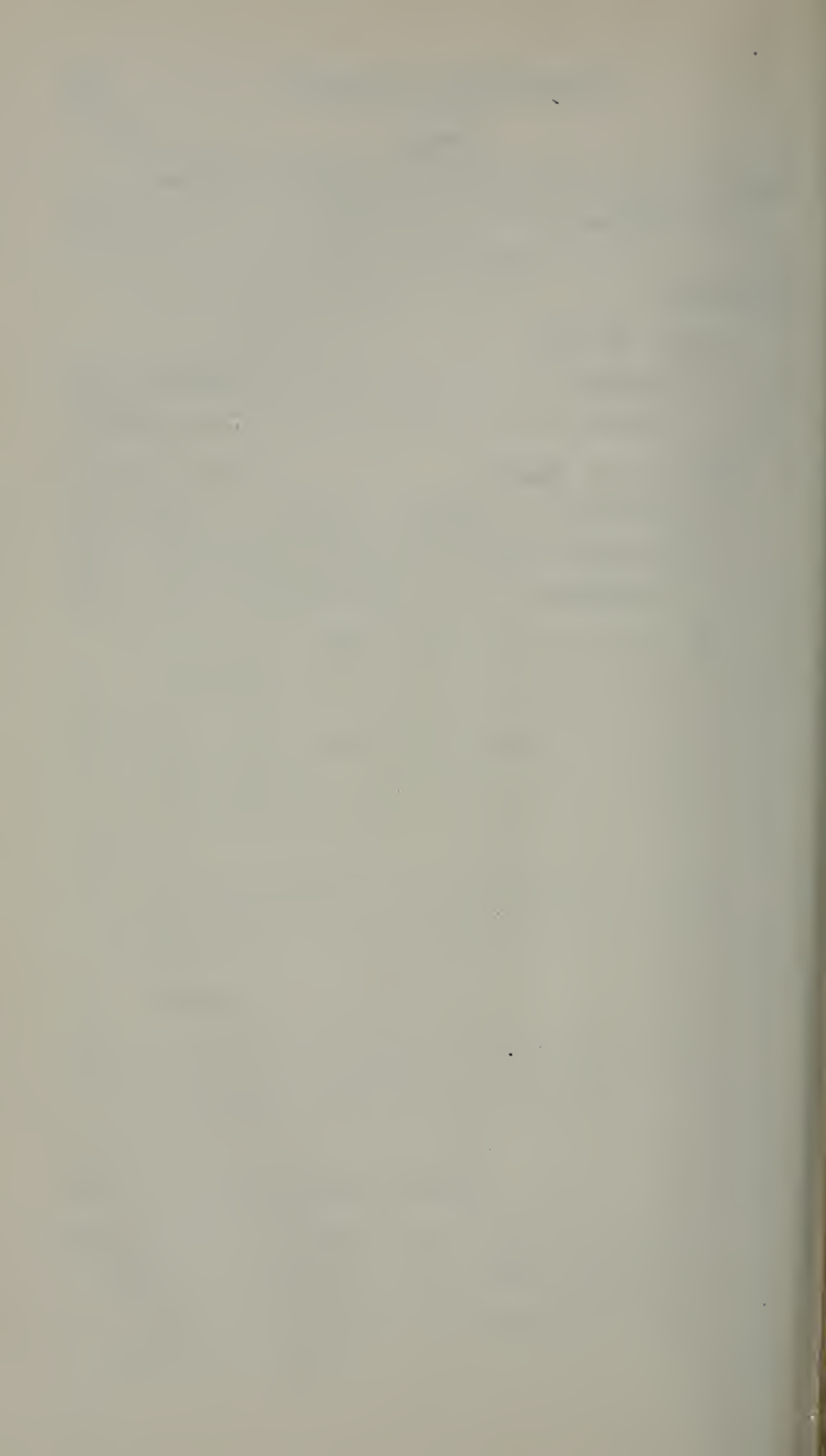
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Northern District of California,

Post Office Building,

San Francisco, California.

In the Southern Division of the United States  
District Court, for the Northern District of  
California

No. 27473-G

MYRTLE CANON,

Plaintiff,

vs.

UNITED STATES OF AMERICA, FIRST DOE,  
SECOND DOE, THIRD DOE, FOURTH  
DOE, FIFTH DOE and SIXTH DOE,  
Defendants.

### COMPLAINT

Plaintiff, Myrtle Canon, complains of defendants  
above named, and for cause of action alleges:

#### I.

Plaintiff is uninformed of the true names of the  
defendants sued herein as First Doe, Second Doe,  
Third Doe, Fourth Doe, Fifth Doe and Sixth Doe;  
said names are fictitious, and plaintiff prays that  
when the true names of these defendants shall be  
ascertained they may be inserted herein in lieu  
thereof together with appropriate charging allega-  
tions.

#### II.

On June 14, 1945, and for a long time prior  
thereto, plaintiff was employed at the DeWitt Gen-  
eral Hospital located at Auburn, California, by the

War Department of the United States of America, as executive Secretary of the Vascular Surgical Section of said hospital; said hospital was owned, operated and managed by the said War Department.

### III.

On the aforesaid day plaintiff was operated upon for varicose veins by employees and agents of said War Department at said hospital; at all times said employees and agents were acting within the course and scope of their employment, agency and authority.

### IV.

Said operation was so negligently performed, and the wound of said operation was so negligently treated by said employees, acting as aforesaid, that as a proximate result of said negligence the wound caused by the operation became badly infected, and a phagadenic ulcer developed.

### V.

Plaintiff continued to be treated by said employees and agents acting as aforesaid at the said DeWitt Hospital until on or about November 24, 1945. At said time said infection and ulcer were active and not cured, but nevertheless, said employees, acting as aforesaid, negligently and carelessly caused plaintiff to be removed from and discharged from said hospital. Said infection and ulcer have not been cured, and plaintiff is informed

and believes, and therefore alleges, that said infection and ulcer will never be cured.

## VI.

As a proximate result of the aforesaid negligence, plaintiff has suffered, and will continue to suffer, excruciating pain and agony. As a further proximate result of the aforesaid negligence, numerous operations, blood transfusions and skin grafts have been necessary, and plaintiff has required, and will continue to require, hospitalization, medical, surgical and nursing attention, blood transfusions and skin grafts for an indeterminable time in the future; plaintiff has been disfigured permanently as a result of the operations and skin grafts necessitated as a proximate result of the negligence of said defendants, acting as aforesaid; plaintiff has been and will continue to be completely bedridden and disabled and unable to perform any kind of work for an indeterminable time in the future.

## VII.

As a proximate result of the negligence and carelessness of the defendants, as aforesaid, plaintiff has incurred, and will incur, an indebtedness for hospitalization and nursing services and for doctor bills; that the true and exact amount of said hospital and nursing and doctor bills are presently unknown to plaintiff, and in this respect plaintiff prays to amend this complaint to include such amounts when the same become known to her.

## VIII.

As a further direct and proximate result of the foregoing, plaintiff was caused to and did suffer, and will continue to suffer, loss of salary and wages as the result of loss of time from her regular employment by reason of the negligence and carelessness of the defendants, and each of them, as aforesaid; that the amount of such loss of salary and wages cannot be ascertained at this time and plaintiff prays leave to amend the within complaint by alleging the true amount thereof when the same become known to her.

## IX.

As a proximate result of the negligence and carelessness of the defendants, plaintiff has been generally damaged in the sum of One Hundred Thousand Dollars (\$100,000.00), no part of which has been paid.

Wherefore, plaintiff prays judgment against the defendants in the sum of One Hundred Thousand Dollars (\$100,000.00), for such items of special detriment as she may prove, for her costs of suit, and for such other relief as may be proper.

/s/ VINCENT HALLINAN,

/s/ JAMES MacINNIS,

/s/ ARCHER ZAMLOCH,

/s/ RALPH WERTHEIMER,

Attorneys for Plaintiff.

[Endorsed]: Filed July 31, 1947.



[Title of District Court and Cause.]

## ANSWER TO COMPLAINT

Comes now defendant United States of America, and answering plaintiffs Complaint herein, denies and alleges as follows:

### I.

Denies the allegations of Paragraphs IV, VI, VII, VIII and IX of said Complaint, and denies the portion of Paragraph III, beginning with the words "at all times," Line 6, Page 2, to and including the word "authority," Line 8, Page 2, and the allegations of the portion of Paragraph V, beginning with the word "Plaintiff," Line 16, Page 2, to and including the word "hospital," Line 21, Page 2.

### II.

Said defendant is without information upon the subject sufficient to enable it to form a belief as to the truth of the allegations contained in the portion of Paragraph V, beginning with the words "Said infection," Lines 21-22, Page 2, to and including the word "cured," Line 24, Page 2, and, therefore, and basing its denial upon said ground, said defendant denies said allegations.

### III.

Denies that plaintiff has been damaged in the sum of \$100,000.00, or any part thereof, or in any sum or amount, or at all.

Wherefore, said defendant prays that plaintiff

take nothing by her Complaint herein, and that said defendant be hence dismissed with its costs.

/s/ FRANK J. HENNESSY,  
United States Attorney.

/s/ DANIEL C. DEASY,  
Assistant U. S. Attorney.

Attorneys for Defendant  
United States of America.

[Endorsed]: Filed February 16, 1948.

District Court of the United States, Northern  
District of California, Southern Division

At A Stated Term of the Southern Division of  
the United States District Court for the Northern  
District of California, held at the Court Room  
thereof, in the City and County of San Francisco,  
on Friday, the 8th day of April, in the year of our  
Lord one thousand nine hundred and forty-nine.

Present: The Honorable Louis E. Goodman,  
District Judge.

No. 27473-G Civil

MYRTLE CANON,

vs.

UNITED STATES OF AMERICA, et al.

FURTHER TRIAL—ORDER GRANTING DE-  
FENDANT'S MOTION FOR JUDGMENT  
OF DISMISSAL

This case came on regularly this day for further  
trial. Ralph Wertheimer, Esq. was present on be-  
half of the plaintiff, and Daniel Deasy, Esq., As-  
sistant U. S. Attorney, was present on behalf of  
the United States. The motion of the defendant for  
a judgment of dismissal having been submitted to  
the Court for consideration and decision and the  
same having been fully considered, it is Ordered  
that said motion be granted in accordance with an  
oral decision this day rendered.

[Title of District Court and Cause.]

## OPINION

Goodman, District Judge.

This suit is one under the Tort Claims Act, 28 USS Sec. 921 et seq. (1948 Revision, 28 USCA 2671 et seq.)

The Court has had under advisement the motion of the United States for dismissal made at the conclusion of the plaintiff's case.

The facts are that plaintiff was a civilian medical secretary or clerk employed in the DeWitt General Hospital at Auburn, California, operated by the Medical Department of the War Department. On June 14, 1945, while she was such employee, Colonel William Smith, commanding officer of the hospital, arranged for her to be operated upon in the Army Hospital for varicose veins in her legs, a disease or ailment with which she had been afflicted for some-time, and which was in no way caused or contributed to by her employment. The operation was performed by Dr. E. Wm. Rector and she received post-operative treatment from both Dr. Rector and Dr. Norman Freeman, chief of the vascular section of the Hospital.

Plaintiff contends that the operation was negligently performed and resulted in infection of the wound, and that such negligence, contributed to by negligence in the treatment of the wound thereafter, caused the infection to develop into a phagadenic

ulcer, a rare and unusual disease. There is no doubt that the infection and resulting phagadenic ulcer have not been healed and that plaintiff has undergone great suffering due to a series of operations and that she has been disfigured, and that her condition, in all probability, is permanent. She seeks damages against the United States in the sum of \$100,000. The evidence, without a doubt, discloses that the damage is great, and, if the liability of the United States is established, an award of the amount prayed for would not be excessive.

The main question presented by the motion to dismiss is whether, assuming negligence of the attending physicians, the United States is liable.

By Section 1346 of 28 USC, Federal Tort Claims Act, the United States waives its sovereign immunity to suits for damages for personal injuries "caused by the negligence or wrongful act or omission by any employee of the government while acting in the scope of his office or employment **under** circumstances where the United States, if a private person, would be liable to the claimant for such damages and \* \* \* in accordance with the law of the place where the act or omission occurred."

By Section 2671, members of the military and naval forces of the United States are declared to be within the term "employee of the government," and in the case of the members of the military and naval forces, the term "acting within the scope of his office or employment" is declared to mean "acting in line of duty."



In waiving its sovereign immunity and consenting to be sued, the United States fixed and bounded the area of its liability. And its liability, as so fixed, cannot, under any equitable or quasi-equitable theory, be extended beyond the stated limits. By this statute, the United States consents to be sued (1) in cases of negligence of employees "while acting in the scope of employment or office" and then only (2) if besides, the circumstances are such that a private person would be liable under the law of the place where the act or omission of the employee occurred. (*Cerri v. U. S.* 80 Fed. Supp. 931.) *U. S. v. Campbell*, 5 Cir. 172 Fed. 2d 500.

The first question to be considered is therefore, what was the "scope of authority" or "line of duty" of the Commanding Officer and the physicians who attended Miss Cannon.

Army Regulation #40-590 promulgated by the War Department August 29, 1944, and in force at the time of the occurrence of the acts alleged in the complaint, prescribed and classified the persons who are entitled to receive treatment and hospitalization in Army Hospitals.

Miss Cannon was not within any classification of persons who were entitled to receive treatment and hospitalization in Army Hospitals. In particular, she was not within any class of civilian employees entitled to receive such treatment in Army Hospitals. Those performing the duties performed by her, were not, by the regulations, admissible to the hospital for treatment or operation or medical at-

tention. All that the evidence showed in this case, according to the testimony of the plaintiff, is that Colonel Smith, upon plaintiff's request that she be given a leave of absence so that she could go to a civilian hospital to have her varicose veins treated, urged and prevailed upon her to remain at the DeWitt Hospital and be operated upon there, so that she would be more readily available for duty after the operation. Plaintiff testified that her services were badly needed in the Hospital and that it was for that reason that Colonel Smith urged her to have the operation there and so arranged for it. That Colonel Smith had no authority under the regulations to tender and perform the medical services, furnished and given to the plaintiff, and also that he had no authority to offer the services of the Hospital to Miss Cannon, is not and was not subject to dispute.

There is no question but that the Government of the United States acts only through its agents with power delegated and defined by statute or regulation, which all who deal with such persons are presumed to know. The United States can be bound only by agents acting within the scope of the authority delegated to them. *Hawkins v. U. S.* 96 U. S. 689; *Wilbur Nat. Bank v. United States*, 294 U. S. 120; *Federal Crop Ins. Corp. v. Merrill*, 332 U. S. 380; *Utah Power & Light Co. v. United States*, 243 U. S. 389; *Roth v. Hood*, 6 Cir. 106 Fed. 2d 616; *Farm Security Admin. v. Herren*, 8 Cir. 165 Fed. 2d 554.

Certainly a private hospital corporation would not be liable, if an interne or resident doctor employed to treat patients regularly admitted to the hospital caused or induced a third party to be operated upon and receive hospitalization without cost or expense to such person, and then negligently treated such person. For in such a case, such acts would not be within the scope of employment under the laws of California. So here the United States cannot be held responsible for the act of a doctor in an Army Hospital who, without any authority and acting clearly beyond the scope of his authority in line of duty, caused to be extended to a person not entitled thereto, services of doctors who were employees of the United States and the services and facilities of a hospital owned and operated by the United States.

It is contended by the plaintiff that the Commanding Officer of the Hospital, in admitting plaintiff to the Hospital and causing medical and hospital services to be extended to her, in fact acted within the scope of his employment because he admitted her to the Hospital as a civilian entitled to treatment, even though he acted erroneously. Having admitted her, counsel says, upon such mistake in fact, the United States nevertheless became bound. However, as previously pointed out, the authority of employees of the United States is defined by statute or rule and all persons dealing with such employees do so at their peril as to the extent of the authority of such employees. See *Hawkins v. U. S.* and other cases cited *supra*.

It is also contended by the plaintiff that even though her admission to the Hospital was an act beyond the scope and authority of the Commanding Officer, there is still responsibility on the part of the United States because of the fact that plaintiff was a licensee, if not an invitee, on the hospital premises. California case citations urged in support of this contention, however, are not in point for they all involve negligent acts of persons acting within the scope of their employment, or involve physical conditions resulting from negligence of agents acting within the scope of their authority. Licensees as well as invitees are not protected against negligent acts of employees acting beyond the scope of their authority or employment.

Some point is also made that the services extended to plaintiff were in a sense for the benefit of the government because of the need of her services at a time of difficulty in obtaining trained medical secretaries and hence there is a consequent responsibility of the United States for the injuries suffered by the plaintiff. However, there is no known doctrine by which responsibility or liability is imposed upon the United States because of any benefit to it, nor does responsibility ensue as a result of estoppel, or like equitable theory.

Since the Officers and employees of the United States here clearly and admittedly acted beyond the scope of their authority, there can be no liability under the Federal Tort Claims Act. While I base decision upon that ground, there is also no doubt

in my mind that the evidence adduced is of such a nature that I would be compelled to make a finding, if the issue were reached, that plaintiff's injury and damage was not the result of or caused by any negligence or mal-practice on the part of the operating or attending physicians.

Motion for judgment of dismissal will be granted. Present findings pursuant to the Rules.

Dated: April 8, 1949.

[Endorsed]: Filed April 29, 1949.

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[Title of District Court and Cause.]

## FINDINGS OF FACT AND CONCLUSIONS OF LAW

The above-entitled action came on regularly for trial before the above-named Court on the 22nd day of March, 1949, at the hour of 10:00 o'clock a.m., Honorable Louis E. Goodman, United States District Judge, presiding.

The plaintiff, Myrtle Canon, was represented by Ralph Wertheimer, Esq., appearing for Messrs. Vincent Hallinan, James MacInnis, Archer Zamloch and Ralph Wertheimer, attorneys for plaintiff herein, and the defendant United States of America was represented by Frank J. Hennessy, Esq., United States Attorney, appearing by Daniel C. Deasy, Esq., Assistant United States Attorney.

Thereupon the Court ordered the trial to proceed,



and oral and documentary evidence was introduced, and the plaintiff having completed the presentation of her evidence and having rested, the defendant United States of America thereupon made a motion for a judgment of dismissal, and said motion having been argued to the Court by counsel and having been submitted, and the Court having considered the law and the evidence, and being fully advised of the law and the facts and the premises, and having made its order granting defendant's motion for a judgment of dismissal herein, the Court finds and makes the following

### Findings of Fact

#### I.

That the Court has jurisdiction to hear and determine said action by reason of the provisions of the Federal Tort Claims Act, Title 28 United States Code, §§921 to 946 (Public Law 601—79th Congress, 2nd Session, Chapter 753, Part IV);

#### II.

That plaintiff on and before June 14, 1945, was a civilian medical secretary employed by the United States at the DeWitt General Hospital at Auburn, California, a hospital operated by the Medical Department of the War Department of the United States;

#### III.

On June 14, 1945, plaintiff was operated upon in said hospital for varicose veins in her legs, a disease

or ailment with which she had been afflicted for some time and which was in no way caused or contributed to by her employment. The operation was performed by Dr. E. William Rector, with the permission of Colonel William Smith, Commanding Officer of said hospital. Plaintiff received post-operative treatment from both Doctor E. William Rector and Dr. Norman Freeman, Chief of the vascular section of said hospital.

#### IV.

Subsequent to said operation an infection appeared at the site of the operative wound. A course of treatment consisting of medication, irrigation of the infected area, and a series of operations, was instituted by the attending doctors in an **attempt** to arrest and cure the infection. In spite of such course of treatment the infection continued to spread and developed into a phagedenic ulcer, a rare and unusual disease. This ulcer continued to spread over the plaintiff's body during the entire time she remained under treatment at DeWitt General Hospital, and thereafter while she was successively a patient at the University of California Hospital in San Francisco, California, the San Francisco City and County Hospital, and two hospitals in Los Angeles, California. At the time of trial herein, the said ulcer was not yet completely healed.

#### V.

On June 14, 1945, and at all times subsequent thereto while plaintiff remained in the DeWitt Gen-

eral Hospital, the said hospital was operated by the Medical Department of the War Department of the United States under army regulations promulgated by the Secretary of War through the Chief of Staff, United States Army, including Army Regulations No. 40-590.

## VI.

Army Regulations No. 40-590, entitled "Medical Department Administration of Hospitals, General Provisions," promulgated August 29, 1944, and in effect on June 14, 1945, designated and enumerated the classes of persons including both civilian and service personnel who might be admitted to Army hospitals and be provided with hospitalization and medical treatment therein. Plaintiff was not a person whose status, duties or employment brought her within any of the classes of persons entitled under said Army Regulation to be admitted to or operated upon or treated in the DeWitt General Hospital.

## VII.

Colonel William Smith, Commanding Officer of DeWitt General Hospital, on June 14, 1945, was not empowered under Army Regulations 40-590 or otherwise, to admit plaintiff to DeWitt General Hospital as a patient nor to authorize an operation for varicose veins to be performed upon her in said hospital, nor to authorize or consent to the use of the facilities of said hospital for such operation or for post-operative treatment of plaintiff, nor was he empowered to order or direct any of the doctors,

nurses or other persons employed by the United States in said hospital or assigned to said hospital for duty as officers or enlisted personnel of the United States Army, to perform any operation upon plaintiff or to render her any surgical, medical nursing or other care, attention or treatment in connection with or for the relief or treatment of the varicose veins with which she was afflicted on June 14, 1945.

### VIII.

Dr. E. William Rector was not empowered under Army Regulations 40-590, or otherwise, to perform an operation upon plaintiff for varicose veins on June 14, 1945, nor to provide her with post-operative surgical or medical care or treatment at DeWitt General Hospital.

### IX.

Dr. Norman Freeman was not empowered, under Army Regulations 40-590, or otherwise, to provide plaintiff with surgical or medical care or treatment at DeWitt General Hospital.

### X.

None of the nurses, doctors, attendants or other employees of the United States employed in, or attached or assigned to DeWitt General Hospital during the time plaintiff was a patient in said hospital, either as civilian employees of the United States or as officers or enlisted personnel of the United States Army, was authorized under Army

Regulations 40-590, or otherwise, to provide plaintiff with medical, surgical, hospital, nursing or any other care, treatment, services or attention in DeWitt General Hospital.

### XI.

Colonel William Smith, Commanding Officer of DeWitt General Hospital had no authority under Army Regulations 40-590 or otherwise, to determine or make any finding that plaintiff was a person within any of the classes enumerated in said regulations as being entitled to admission to said hospital as a patient.

### XII.

In admitting plaintiff to said hospital as a patient, Colonel William Smith was not acting in line of duty; in authorizing Dr. Rector to operate upon her, he was not acting in line of duty; in consenting to her post-operative treatment, he was not acting in line of duty.

### XIII.

In operating upon plaintiff on June 14, 1945, Dr. E. William Rector was not acting in line of duty; in treating her surgically and medically subsequent to said operation, he was not acting in line of duty.

### XIV.

In treating plaintiff surgically and medically subsequent to the operation performed upon her by Dr. E. William Rector, Dr. Norman Freeman was not acting in line of duty.



XV.

In providing hospital, nursing and other care, treatment, services and attention to plaintiff, none of the doctors, nurses or other civilian or military personnel employed at, attached to, or assigned to duty in the DeWitt General Hospital, was acting in line of duty.

XVI.

The allegations of paragraph II of plaintiff's complaint are true.

XVII.

It is true that plaintiff was operated upon for varicose veins by employees of the United States at DeWitt General Hospital.

XVIII.

No finding is made as to the allegations of paragraph IV of plaintiff's complaint, except that the wound became infected and a phagedenic ulcer developed.

XIX.

No finding is made as to the allegations of paragraph V of plaintiff's complaint, except that plaintiff continued to be treated at the DeWitt General Hospital until about November 24, 1945, at which time she was discharged from said hospital by reason of the fact that it was being deactivated by the Medical Department of the United States Army, and except that at the time plaintiff left DeWitt General Hospital, the phagedenic ulcer was not

cured and that at the time of trial of this action it was not cured.

## XX.

No finding is made as to the allegations of paragraph VI of plaintiff's complaint, except that plaintiff has suffered and is now suffering great pain, that numerous operations were performed upon plaintiff subsequent to the development of said phagedenic ulcer, that she was given numerous blood transfusions and skin grafts, that she still requires medical attention and will require such attention in the future, and that plaintiff has been disfigured as a result of such ulcer, operations and skin grafts.

## XXI.

No finding is made as to the allegations of paragraph VII of plaintiff's complaint, except that plaintiff has incurred indebtedness for hospitalization, nursing services and doctor bills.

## XXII.

None of the allegations of paragraph VIII of plaintiff's complaint are true.

## XXIII.

None of the allegations of paragraph IX of plaintiff's complaint are true.

## XXIV.

By reason of the findings of fact heretofore made, to the effect that the Government employees involved herein were not acting at any time within

the scope of their employment in connection with the admission of plaintiff as a patient to DeWitt General Hospital, the operation upon her for varicose veins and post-operative treatment and hospitalization afforded her, the Court deems it unnecessary to make any findings as to whether or not any of the said employees of the United States were negligent or careless or guilty of malpractice, or any careless or wrongful act or omission in the said operation, hospitalization or treatment afforded to said plaintiff.

### Conclusions of Law

From the foregoing facts this Court finds that:

#### I.

None of the persons who operated upon plaintiff or who provided her with hospitalization, surgical services, medical treatment, nursing care or other services, treatment, care or attention in DeWitt General Hospital on June 14, 1945, or at any time subsequent thereto, were acting within the scope of their employment by the United States, or in the line of duty.

#### II.

Plaintiff is not entitled to recover any damages against the United States of America herein.

#### III.

Defendant United States of America is entitled to judgment of dismissal upon its motion to dismiss said action.

## IV.

Defendant United States of America is entitled to recover from plaintiff its costs of suit herein.

Let judgment be entered accordingly.

Done in open Court this 21st day of June, 1949.

/s/ LOUIS E. GOODMAN,

United States District Judge.

Lodged June 13, 1949.

[Endorsed]: Filed June 21, 1949.

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District Court of the United States, Northern  
District of California, Southern Division

At a Stated Term of the Southern Division of the United States District Court for the Northern District of California, held at the Court Room thereof, in the City and County of San Francisco, on Tuesday, the 30th day of August, in the year of our Lord one thousand nine hundred and forty-nine.

Present: The Honorable Louis E. Goodman,  
District Judge.

[Title of Cause.]

## ORDER FOR ENTRY OF JUDGMENT

Ordered judgment entered in the form this day signed.

[Title of District Court and Cause.]

## JUDGMENT

This cause came on regularly for trial before the United States District Court for the Northern District of California, Southern Division, Honorable Louis E. Goodman, United States District Judge, presiding, Messrs. Vincent Hallinan, James MacInnis, Archer Zamloch and Ralph Wertheimer, by Ralph Wertheimer, appearing for the plaintiff, Myrtle Canon, and Frank J. Hennessy, United States Attorney, by Daniel C. Deasy, Assistant United States Attorney, appearing for the defendant, United States of America; whereupon said cause proceeded to trial, and oral and documentary evidence having been introduced and the plaintiff having rested her case, the defendant United States made its motion for a judgment of dismissal, and said motion having been argued by counsel and having been submitted, and the Court being fully advised in the premises, and having filed herein its findings of fact and conclusions of law, and having directed that judgment of dismissal be entered in accordance with the findings of fact and conclusions of law;

Now, Therefore, by reason of the law and findings as aforesaid, It Is Hereby Ordered, Adjudged and Decreed that the above-entitled action be, and it is hereby, dismissed and that the defendant United States of America have judgment against plaintiff



Myrtle Canon for its costs of suit herein taxed  
at \$.....

Done in Open Court this 30th day of August,  
1949.

/s/ LOUIS E. GOODMAN,  
United States District Judge.

Approved as to form:

HALLINAN, MacINNIS, ZAM-  
LOCH, WERTHEIMER,  
/s/ RALPH WERTHEIMER,  
Attorneys for Plaintiff  
Myrtle Canon.

[Endorsed]: Filed August 30, 1949.

Entered in Civil Docket August 31, 1949.

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[Title of District Court and Cause.]

### NOTICE OF APPEAL

To the defendant, United States of America, and  
to Frank J. Hennessy, Esq., its attorney:

Notice is hereby given that Myrtle Canon, plain-  
tiff above named, hereby appeals to the Court of  
Appeals, Ninth Circuit, from the judgment hereto-  
fore entered in this action on the 31st day of Au-  
gust, 1949.

HALLINAN, MacINNIS &  
ZAMLOCH,  
RALPH WERTHEIMER,  
/s/ RALPH WERTHEIMER,  
Attorneys for Plaintiff.

[Endorsed]: Filed September 28, 1949.

[Title of District Court and Cause.]

DESIGNATION OF CONTENTS OF  
RECORD ON APPEAL

To the Clerk of the United States District Court  
for the Northern District of California, South-  
ern Division:

Please include in the record on appeal the fol-  
lowing:

1. Complaint;
2. Answer;
3. Reporter's Transcript;
4. Minute Order of April 8, 1949;
5. Opinion;
6. Findings of Fact and Conclusions of Law;
7. Judgment;
8. Notice of Appeal;
9. Designation of Record on Appeal.

Dated: November 2, 1949.

HALLINAN, MacINNIS &  
ZAMLOCH,

By /s/ RALPH WERTHEIMER,  
Attorneys for Plaintiff  
and Appellant.

[Endorsed]: Filed November 3, 1949.

[Title of District Court and Cause.]

SUPPLEMENTAL DESIGNATION OF  
CONTENTS OF RECORD ON APPEAL

Defendant-Respondent respectfully supplements the Plaintiff-Appellant's "Designation of Contents of Record on Appeal" filed herein on November 3, 1949, and requests the following documents be forthwith added to and made part of the contents of said record on appeal, to-wit:

Any and all exhibits filed by either plaintiff or defendant in the District Court.

Dated: December 23, 1949.

/s/ FRANK J. HENNESSY,  
United States Attorney,

/s/ CHARLES O'GARA,  
Assistant U. S. Attorney,  
Attorneys for Defendant  
U. S. of America.

Affidavit of service by mail attached.

[Endorsed]: Filed December 23, 1949.

[Title of District Court and Cause.]

CERTIFICATE OF CLERK TO  
RECORD ON APPEAL

I, C. W. Calbreath, Clerk of the District Court of the United States for the Northern District of California, do hereby certify that the foregoing documents, listed below, are the originals filed in this Court, or true and correct copies of orders entered on the minutes of this Court, in the above-entitled case, and that they constitute the Record on Appeal herein, as designated by the Appellant, to-wit:

Complaint.

Answer to Complaint.

Minute Order of April 8, 1949—Order Granting Defendant's Motion for Judgment of Dismissal.

Opinion.

Findings of Fact and Conclusions of Law.

Minute Order of August 30, 1949—Order for Entry of Judgment.

Judgment.

Notice of Appeal.

Designation of Contents of Record on Appeal.

In Witness Whereof, I have hereunto set my hand and affixed the seal of said District Court this 4th day of November, A.D. 1949.

C. W. CALBREATH,  
Clerk,

[Seal]: By /s/ M. E. VAN BUREN,  
Deputy Clerk.

[Title of District Court and Cause.]

CERTIFICATE OF CLERK TO SUPPLEMENT  
TO RECORD ON APPEAL

I, C. W. Calbreath, Clerk of the District Court of the United States for the Northern District of California, do hereby certify that the foregoing document and accompanying Exhibits, listed below, are the originals filed in this Court, in the above-entitled case, and that they constitute the supplement to the Record on Appeal herein, as designated by the Appellees, to wit:

Supplemental Designation of Contents of Record on Appeal.

Plaintiff's Exhibits Nos. 1, 2 (in two parts), 3 (in two parts), 4, 5, 6, 7, 8 and 9.

In Witness Whereof, I have hereunto set my hand and affixed the seal of said District Court, this 4th day of January, A.D. 1950.

C. W. CALBREATH,  
Clerk,

[Seal]: By /s/ M. E. VAN BUREN,  
Deputy Clerk.



[Title of District Court and Cause.]

CERTIFICATE OF CLERK TO  
REPORTER'S TRANSCRIPT

I, C. W. Calbreath, Clerk of the District Court of the United States for the Northern District of California, do hereby certify that the following Reporter's Transcript was filed in the above-entitled case, and is herewith forwarded to the United States Court of Appeals for the Ninth Circuit, to be considered by it as part of the Record on Appeal, herein, to wit:

Reporter's Transcript for March 22, 1949.

Witness my hand and seal of the District Court of the United States for the Northern District of California this 7th day of December, A.D. 1949.

C. W. CALBREATH,  
Clerk,

[Seal]: By /s/ M. E. VAN BUREN,  
Deputy Clerk.

In the United States District Court for the North-  
ern District of California, Southern Division

No. 27,473-G

MYRTLE CANON,

Plaintiff,

vs.

THE UNITED STATES,

Defendant.

Before: Honorable Louis E. Goodman,  
United States District Judge.

Tuesday, March 22, 1949

Appearances:

RALPH WERTHEIMER, ESQ.,  
For the Plaintiff.

FRANK J. HENNESSY,  
United States Attorney, by

DANIEL DEASY,  
Assistant United States Attorney.  
For the United States Government.

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## PROCEEDINGS

(Argument on Motion to Dismiss.)

The Court: I think we might proceed with your evidence.

Mr. Wertheimer: Very well, your Honor.

Now, I am in this position. I have asked Dr. Efnard, who is a doctor for Miss Canon, to come

up *her* from Los Angeles. He will be here tomorrow. At that time I expect to ask him certain questions based upon evidence which I thought would be in at this time. That evidence is contained in the records of the DeWitt Hospital.

I had expected to be able to—hoped to have read it into the record. I think the only thing I could do at this time—I have gone over the record with a great deal of patience—is to offer it in evidence. The record, all of the records pertaining to the treatment given to Miss Canon at the DeWitt General Hospital at Auburn, California, from the time the records commenced which is prior to her operation on June 14, 1945, until her transfer to the University of California Hospital. I would like to offer those in evidence.

The Court: You are offering the records as business records of the hospital?

Mr. Wertheimer: Yes.

The Court: All things that have to do with the treatment that was given to the lady in the hospital, is that right?

Mr. Wertheimer: Yes. [2\*]

The Court: I have ruled in some of these cases that that is admissible in evidence under the business record rule but that it does not permit the introduction of any opinions or diagnoses of doctors which might be included in the record, because that would be hearsay without any opportunity of cross-examining the doctor. In other words, I think you are familiar with that.

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\* Page numbering appearing at top of page of original Reporter's Transcript.

Mr. Wertheimer: I think that is a correct ruling.

The Court: Yes, I think that is correct.

Mr. Deasy: I have no objection to the admission of the records in so far as they show—as they are records of the day by day procedures of treatment, but where there are—all reports, reports of——

The Court: Chemical, pathological and laboratory reports.

Mr. Deasy: Laboratory reports and things of that kind, but the statements in there of the doctor's notes made in there as to what he thinks about things and his opinions.

The Court: That is just what I have just stated.

Mr. Deasy: I object to those.

The Court: I will admit the records in evidence except any records of the opinions of doctors that might be contained. They would be subject to the hearsay rule.

Mr. Deasy: I think, your Honor, in these particular records there is some correspondence between doctors and [3] various other people, including members of the plaintiff's family, if I recall correctly. I don't know whether those would be admissible under the same theory.

Mr. Wertheimer: I don't think they would be.

The Court: Well, the record is admitted only to the extent that it contains day by day records of what happened to the lady in the hospital and the treatments that were afforded her, bacteriological, X-ray and other reports and excluding anything else that would be the subject of the hearsay rule.

Mr. Wertheimer: I think that is, your Honor, a correct statement or a correct ruling. There may be, I think there may be, and I may be anticipating some conflict between myself and Mr. Deasy as to what falls within the admissible and not——

The Court: In offering the ruling will be subject to a motion to strike as to any particular matter that the Court's attention is called to.

Mr. Deasy: Yes.

Mr. Wertheimer: All right, sir.

Mr. Deasy: Are those three groups hospital records?

The Court: This is just the DeWitt Hospital records.

Mr. Deasy: That is the group that was introduced on a preliminary hearing?

The Court: You are only offering the DeWitt Hospital [4] records?

Mr. Wertheimer: Yes.

The Court: Very well. Mark it then.

The Clerk: Are those mixed up in this group (indicating)?

The Court: You had better point out to the Clerk which is the record so that he will know what to mark.

Mr. Wertheimer: I think I will have to—the difficulty there, your Honor, is in the form in which they came, they are a little bit mixed up. It isn't a difficult job to separate them but I think I can go over them with the Clerk and if Mr. Deasy wants to be there when I do it——



The Court: You mean there are some things that are not records of the DeWitt Hospital?

Mr. Wertheimer: There are some from Tormey.

The Court: They are all included in one envelope. Have you got the record there that separates the two?

Mr. Deasy: No, your Honor. This (indicating) is mixed up even more than the others. I received this subsequent to the time we deposited these with the Court. These are all bound together and sealed up and certified here. I was just looking and I see they do have things which are headed Tormey General Hospital.

The Court: Maybe you could agree between you that you may take out of that record that you have there anything [5] that does not pertain to the DeWitt Hospital and then you could do that before tomorrow morning and then have the—what is left strictly from the DeWitt Hospital marked in evidence.

Mr. Deasy: We have to examine each page, your Honor.

The Court: Well, suppose that Mr. Wertheimer either take your record or the other record, it doesn't make any difference to the Court, after the recess and after we adjourn and get what you want included in what will be Plaintiff's Exhibit 3, in proper shape and then make the offer tomorrow morning, but I will make the order I have already made with respect to the exhibit as you present it tomorrow morning.

Mr. Wertheimer: Miss Canon.

Thereafter

MYRTLE CANON

called, sworn, testified as follows:

The Clerk: Will you state your name to the Court?

A. Miss Myrtle Canon.

The Clerk: Miss Myrtle Canon.

Direct Examination

By Mr. Wertheimer:

Q. Miss Canon, you are the plaintiff in this action, is that right? A. Yes, sir.

Q. Now, where do you live, Miss Canon? [6]

A. Well, I have, for the last year I have been in the California Hospital in Los Angeles and then I stayed with my aunt who is a nurse in Los Angeles.

Q. What is your present address?

A. Right now I am staying at the Hotel Albert here in San Francisco.

Q. But I mean in Los Angeles.

A. 2228 South Ridgely Drive.

Q. Now, how old are you? A. 36.

Q. And where were you born?

A. Lewiston, Montana.

Q. And did you move from there to Los Angeles?

A. Yes, I moved from there to Los Angeles when I was 15. That was in October of 1928, I believe.

Q. And where did you—When did you first go to work? A. For the Army, you mean?

(Testimony of Myrtle Canon.)

Q. No.

A. Well, I graduated from Santa Monica High School in 1931 and then I started working in various surgeons' offices in Santa Monica, and then I worked at the Culver City Hospital.

Q. You graduated from Santa Monica High School in 1931, and what was your first employment and where?

The Court: Do you need to go into that?

Mr. Wertheimer: Just a little background. [7]

Q. Let me ask you this: Did you act as a medical secretary prior to your going to work for the Army at Tormey Hospital in October of 1944?

A. Oh, yes, I worked in Dr. Adolph Koski's office in——

Mr. Deasy: Doctor who?

A. Koski, in Santa Monica.

Q. (By Dr. Wertheimer): Now, was he the first—was he your first——

A. (Interrupting): He was the first surgeon that I worked for.

Q. And he was a surgeon, was he?

A. He was a surgeon.

Q. How long did you work for him?

A. Oh, I had known Dr. Koski off and on for several years. I used to just relieve when his nurse went on a vacation I would say for three or four years in the summer time.

Q. Just in the summer time, is that right?

A. Well, usually when the girls went on a vaca-

(Testimony of Myrtle Canon.)

tion and then when I wasn't in his office I would relieve the nurse in other doctors' offices. I worked in Dr. James Ramsey's office in Santa Monica, and I worked for Dr. Kenneth McLaren, who is also a doctor in Santa Monica, and following that I worked in various hospitals. I worked in the California Lutheran and then I left there and——

Q. (Interrupting): Just a moment. Were you a medical secretary to the doctors you named, Koski and Ramsey? [8]

A. Doctor's office assistant. You do secretarial work and assisting.

Q. You act both as a nurse——

A. That is right.

Q. ——and as a medical secretary?

A. Only I wasn't an R.N., or didn't give any narcotics or anything like that, but you assist with dressings and treatments and that sort of thing, examinations.

Q. Now, did you work for any other private doctors before you came to work for the Army?

A. Yes, I worked for Dr. Arthur Smith in Los Angeles. He is a plastic surgeon.

Q. How long did you work for him?

A. I relieved his nurse while she was on vacation and I was in the office, I think, about seven months. I assisted him with surgery which was performed in the office and photographs and assisted the receptionist and I took his graduate nurse's place while she was on vacation is what I did.

Q. Any other doctors?

A. That was the last doctor I worked for before I went to work for the Army.

Q. I see. Now did you work for any hospitals prior to coming——

A. (Interrupting): Yes, I worked at the Culver City Hospital. I went to work as a nurse's aide. They put me on as an [9] undergraduate. I was also a first aid instructor for the American Red Cross. I worked at the Cedars of Lebanon Hospital in the delivery room, and I worked at the California Hospital in surgery.

Q. We don't want to spend too much time on background, but what were your duties at these hospitals? Were you a nurse or a medical secretary?

A. I was a nurse's aide. You can't work as a nurse unless you are an R.N. I wasn't doing secretarial work in the hospital. I knew—in the California Hospital I knew the surgical set-up, the autoclaving and all that sort of thing, so I worked just in surgery.

Q. I see.

A. I did all of the instruments. I even instructed the student nurses at times on instruments because I like instruments and I knew instruments well, I think.

Q. Did you receive instructions in these hospitals on these instruments?           A. Yes, yes.

Q. What training did you have as a medical secretary prior to your going to work in the Army?

A. I took some business training when I was in



(Testimony of Myrtle Canon.)

school and then Dr. Koski—I got most of my medical training actually postgraduate training at Dr. Koski's, Ramsey's and McLaren's offices. [10]

Q. I mean you learned to type?

A. I took typing at school.

Q. And did you learn to take dictation?

A. I did take shorthand but I didn't take too much shorthand. I did—most of those doctors had regular secretaries and I just assisted them. I didn't have full responsibility of the office.

Q. Now, did you work for the—did you work for any other hospitals or doctors prior to your going to work for the Army?

A. Just those that I mentioned.

Q. Just the ones you mentioned. Now, did you go to work for the Army?

A. Yes, I went to work for the Army.

Q. When? A. December '43.

Q. December of 1943?

A. It was either late December or early January. I believe my appointment was in December. I had taken the Civil Service examinations some months prior to that.

Q. Had you passed?

A. Yes, I took all of them. I took the L. A. City and County Board of Education, the State and the Federal, and I passed all of them, but I was given the privilege on my civil service employee appointment because of my medical [11] training. They

(Testimony of Myrtle Canon.)

needed medical secretaries at that time in the Army Hospitals.

Q. Now, what was your rating when you went to work for the hospital at Tormey?

A. At Tormey I went to work as a CAF-2, Clerk-typist.

Q. CAF-2, Clerk-typist. Where is Tormey located? A. Palm Springs, California.

Q. And what sort of work did you do there?

A. Well, I was in payroll just a few days and then I was in physio-therapy for a few weeks until they had—they found out that I had had plastic surgery, had worked for a plastic surgeon and was familiar with plastic surgery terminology, so I was made secretary to the Chief of Plastic Surgery in Burn Section. That was Major Gilbert Hyroop.

Q. Secretary, you say, of the plastic surgery section?

A. Plastic surgery burn section.

Q. Now, how long did you work there? When did you quit, when did you leave Tormey?

A. I left Tormey in October of 1944 and I transferred to DeWitt General Hospital.

Q. You transferred? A. Yes, transferred.

Q. At the time of your transfer, what was your rating?

A. I had been raised to, promoted to CAF-3.

Q. I see. Do you remember what the rate of pay for a [12] CAF-3 was at that time?

A. It was \$1620 per annum.

(Testimony of Myrtle Canon.)

Q. That was gross? A. Gross.

Q. And what was CAF-2, \$1440, I believe?

A. \$1440.

Q. Now, you were transferred to the DeWitt Hospital at Auburn? A. That is right.

Q. And for whom—when did you go to work there?

A. I went to work in October of 1944. I don't remember the date offhand.

Q. And who did you go to work for there?

The Court: Can't you ask leading questions on this and shorten it? Just ask her what job she had there and what her duties were. Would you answer that for me, what did you do at DeWitt?

A. Yes, I was secretary, I was executive secretary of the vascular surgical section up there. I went up there——

The Court (Interrupting): Never mind: You went. I was trying to shorten it and I just wanted to find out what you did. You were—besides that, did you do that work right along until the time you were operated on?

A. Yes, I did. I had a terrific amount of responsibility. I did all of the typing and all of the filing and I did all [13] of the monthly reports and I did all of the CDD reports and I did all of the retirement reports and I scheduled all surgery and when I scheduled—when they asked me to schedule surgery they would merely state the patient's name——

The Court: This is getting too much into detail.

(Testimony of Myrtle Canon.)

Now, you performed this work right up until the time you were operated on?

A. That is right. We went——

The Court (Interrupting): As secretary in this department.

A. We had almost 600 in that section at a time. I used to work up until six o'clock the following morning.

The Court: Go ahead, Mr. Wertheimer.

Q. (By Mr. Wertheimer): The Commanding Officer of that hospital was a man by the name of Smith? A. Colonel William Smith.

Q. And the man in charge of surgery was, general surgery, was Lt. Col. Stark?

A. Yes, Lt. Col. Stark was Chief of Surgical Services.

Q. He was Chief of Surgical Services?

A. That is right.

Q. At the time you first went to work there who was the head of vascular surgery?

A. Col. Kleinsasser was Chief then.

Q. Now, did Col. Kleinsasser stay there, did he, all of the [14] time you were there?

A. No, he went, he was transferred to an overseas installation on or about the 1st of May.

Q. And who took over his duties?

A. Major Norman Freeman.

Q. Now, did you have—did you work long hours there?

The Court: She has already told us that.

(Testimony of Myrtle Canon.)

Q. (By Mr. Wertheimer): Had you accumulated a lot of overtime?

A. I certainly had.

Q. Prior to your operation on June the 14th?

A. I certainly did. I worked every Saturday, Sunday and holiday.

Q. And did your work call for circulating about the wards to any extent?

A. Yes. I had to make the rounds with the doctors of all of the wards. We had five wards, and we had approximately 600 patients.

Q. Now, prior to your going to DeWitt had you had varicose veins?

A. Yes, I have had them for several years.

Q. You had had them for several years prior to going——

A. (Interrupting): But they didn't bother me.

Q. Had they worsened while you were up there?

A. Oh, yes. After I was on my feet a great deal up there [15] my legs used to ache me so bad when I would go home I could hardly stand it sometimes.

Q. Now, did you have an operation for varicose veins while you were in DeWitt Hospital?

A. Yes, I did on the 14th of June, 1945.

Q. And can you tell us the circumstances that led up to the performance of that operation?

A. Well, on or about the 1st of May I submitted my resignation to Colonel Stark. He refused to accept my resignation and tore it up and threw it in the waste basket on the basis—because he told



(Testimony of Myrtle Canon.)

me that I—in the first place medical secretaries were hard to obtain in that section and I used to help other sections besides mine. He said Major Kleinsasser had gone and Major Freeman was on his way in, and he said it would be my responsibility to see that the section ran smoothly until Major Freeman got his feet on the ground. That was the exact words that he said, so he asked me if there was anything else I would like.

Q. Now, this conversation occurred about the 1st of May, 1945?

A. It was around the 1st of May.

Q. In the Office of Colonel Stark?

A. In the Office of Colonel Stark.

Q. Who was head of the Surgical Service?

A. That is right. [16]

Q. Was there anyone else present besides yourself and Colonel Stark?

A. Well, his secretary was in the adjoining room. There was just an archway——

Q. (Interrupting): I see. Now, what else occurred at that conversation?

A. Oh, then I asked him if I could have some leave because I hadn't been off the post only one day and that was Christmas day of 1944. I told him I was tired and I wanted to get away for a while and he said that that wasn't the time for me to take my leave because of this new officer coming in.

Q. That would be Major Freeman?

(Testimony of Myrtle Canon.)

A. Major Freeman.

Q. —Who was going to take over vascular surgery?

A. That is right, he was on his way from China. So he asked me if there was anything else that he could do for me and I told him then that I had these varicose veins and that they were bothering me and I would like to go to a civilian hospital because I had Blue Cross Insurance and I planned to come down to San Francisco—I had planned San Francisco really for a ligation, and then he says, “Well——

Q. (Interrupting): Did you tell him that?

A. Yes, sir.

Q. That is exactly what you told him? [17]

A. That is exactly what I told him.

Q. Yes.

A. And he says well, we will do it here for you because we can get back on the job in two or three days. He told me, he stressed the fact he didn't have a replacement for me, that I was the only girl in the hospital up there that actually knew medical terminology as well as Army routine.

Q. Did he say anything to you about the possibility of continuing your work while you were in bed if you stayed up there?

A. Yes, that is another thing. He said, I have another stenographer who was helping me and she came in, oh, the latter part of April. She made the rounds with the doctors and he said that Mrs. Cole

(Testimony of Myrtle Canon.)

could take over my office but she didn't know the boards as I did, the boards and the final diagnosis and that sort of thing and he said as a matter of fact while you are still in the hospital if there is anything arises on the section Mrs. Cole can bring the charts down for your O.K., because I O.K.'d every chart that went out of the office. I even wrote the final summary of the section for Major Kleinsasser and I wrote all of the final summaries for Major Freeman, I didn't——

Q. He suggested you continue your work while you were in the hospital, in bed in the hospital?

A. That is right. [18]

Q. Anything else said at that time about the operation?

A. Well, the only thing that he did tell me he said when do you want it done? He told me I could have it done at any time that I wanted to at my convenience, and then the only thing he said was Major Freeman is going to have a month's leave when he comes in, and he said when Major Freeman is gone the work on the section will be relatively light because there will be no surgery, big surgery going on, and you can have your surgery then while Major Freeman is away. He said Captain Rector can't do it because he will be acting—Acting Chief in Vascular in Major Freeman's absence.

Q. Did he say anything about getting any O.K. on the operation from——

A. Yes. When he mentioned the fact to me about

(Testimony of Myrtle Canon.)

having the surgery done in an Army hospital I didn't say anything, but he said I will call—I will talk it over with Colonel Smith, is what he said.

Q. Who was Colonel Smith?

A. Colonel Smith was our Commanding Officer. He said I will call you in the morning and let you know. He said why don't you take the afternoon off because you have been working so hard, and I said, No, I have got about six boards coming up in the morning so I went on back to the office. I didn't take any time off. He called me early the next morning and told me I could have my surgery then [19] any time I liked.

Q. Then what did you do?

A. Well, Major Freeman came in and I worked with him for about six weeks and then he left and took a month's leave and went back to Philadelphia.

Q. And about when did he leave, do you recall?

A. He left just a few days before I went to the hospital, as I remember.

Q. About—

A. I would say around the 10th of June.

Q. By the way, do you know of your own knowledge whether the hospital—where is the hospital located at Auburn?

A. It was outside of Auburn, it was about 10 or 12 miles north.

Q. Ten or twelve miles north. Do you know whether or not the hospital was having difficulty getting help at that time?

A. I know they were because Major Kleinsasser

(Testimony of Myrtle Canon.)

had asked for an assistant for me for months and personnel said they just couldn't get anybody. Once in a while they would send me a soldier's wife who was—you know, a soldier's wife following her husband around the camps, but they couldn't get—they didn't know medical terminology and they didn't know Army routine, and by the time you instructed them, most of them weren't interested in the work anyway and it [20] took me twice as long to instruct them than maybe having to do their work over so I decided to do it myself because I could do it once and get it out of the way.

Q. Did you hear any of the personnel people or Colonel Stark or Colonel Smith comment on the difficulty of obtaining help?

A. Oh, yes, it was generally acknowledged around there that it was hard to get help up there.

Q. Was that due to the war effort in bringing—

Mr. Deasy: I object to that.

The Court: Yes, sustained.

Mr. Deasy: As immaterial and calling for her conclusion.

Q. (By Mr. Wertheimer): Do you know whether it was due in part to the fact that Auburn was relatively isolated?

Mr. Deasy: I make the same objection.

The Court: Yes, that is mere accumulative what is the reason for it. She has already stated that it was difficult to get help.



(Testimony of Myrtle Canon.)

By the way, what was your rating at the time you had the operation?

A. I was still CAF-3. Major Kleinsasser had before he left recommended my promotion to -4, but they didn't act on it and then Major Freeman came and when they came down from personnel and asked them about me he said, "Miss Hawkins [21] I have only seen Miss Canon for a couple of weeks, but I can tell you this much, she is not the run of the mill."

The Court: Madam, really this conversation is all immaterial. All I want to find out is what your rating was. You hadn't yet had a raise in rate at the time of the operation actually, is that right?

A. No, but they acted on it.

The Court: You would have gotten it?

A. I would have gotten it.

The Court: All right.

Q. (By Mr. Wertheimer): You had been recommended for CAF-4, is that correct?

A. That is right.

Q. And as I understand it—had that been acted upon, do you know?

A. It finally was acted upon and they refused it because I wasn't the secretary to a chief of a service. I was a section chief secretary and those jobs were all so—literally, they were sewed up, the three jobs.

Q. Had you received the normal promotions at the time of the operation, if you remember?

A. Yes, I had.

(Testimony of Myrtle Canon.)

Q. Do you remember what your salary was at the time you were operated on on June 14th?

A. I think it was 1920. [22]

Q. Around 1920, is that your best recollection on the point? A. Yes, as I remember it.

Q. Now, did anybody examine you prior to your operation that was performed upon you, upon your first varicose vein? A. At DeWitt, you mean?

Q. Yes.

A. Yes, Captain Rector examined me. So did Major Kleinsasser and so did Major Freeman and Phlebro Graphs were also taken.

Q. Phlebrographs?

A. That is where they inject fluids into the veins to take x-rays.

Q. And it was then determined that Dr. Rector would perform the operation?

A. That is right.

Q. While Major Freeman was away?

A. That is right.

Q. And the work was lighter?

A. That is right.

Q. Now, do you remember whether or not you had any—the operations were performed when, do you recall that? June the 14th, was it?

A. The 14th of June.

Q. The 14th of June. Now, did you have a routine examination before the operation?

A. Oh, yes. [23]

(Testimony of Myrtle Canon.)

Q. Were you suffering from any infection of any kind—— A. No.

Q. ——prior to the operation?

A. I wasn't. They told me I was in excellent physical condition other than the varicose veins in my legs.

Q. And who told you that?

A. Captain Rector.

Q. And he took a urinalysis, did he?

A. I had a urinalysis, a routine CBC. We make——

The Court: What is a CBC?

A. A complete blood count and bleeding and clotting time.

Q. (By Mr. Wertheimer): And a test for white cells? A. That is the CBC.

Q. That is the CBC. Now, what was your weight, if you recall, at the time you were operated upon?

A. I think it was around 190. Between 185 and 190. I think I was nearer 90.

Q. And you were in good health?

A. Yes, I was.

Q. Now, do you recall being operated upon on June the 14th, 1945? A. That's right.

Q. And you had some experience with operations of that kind, isn't that correct?

A. Oh, yes, we had lots of them on the section.

Q. Then were you under an anesthetic when the operation was performed?

A. They start under a local but they finish it

(Testimony of Myrtle Canon.)

under sodium pentethol so it was completed under a general anesthetic. I wasn't awake.

Q. But you were returned to your room, returned to—it was a private room or was it a ward?

A. I was in a private room in the beginning.

Q. Now, did you recover consciousness after the operation?

A. Oh, a short time afterwards. I don't know how long it was.

Q. And where had the—where had the surgery been performed, when had the incisions been made?

A. Well, they had made incisions in the calf of the leg to take out what they call——

Q. (Interrupting): Which leg was this?

A. They only did one. They intended to do the two of them but Colonel Stark——

Mr. Deasy: I move to strike out what they intended to do.

The Court: Yes. The lady's left leg is the only leg that was operated on.

Mr. Wertheimer: That is right.

Q. Now, what incisions did they make?

A. They made one on the, what they call the medial aspect [25] of the calf.

Q. Show——

A. (Interrupting): It is on the inside of the calf of the leg and another one in the popliteal space, which is in the joint of the knee.

Q. In what space?                      A. The popliteal.

Q. And where is that?

(Testimony of Myrtle Canon.)

A. That is right in the bend of the knee.

Q. Right in the bend of the knee there, indicating the inside, is that correct?

A. And that is the medial aspect (indicating), yes, and then inside——

Q. (Interrupting): Any other incision?

A. And then they do the actual tying off of the, of what they call the saphenous vein at the junction of the femoral artery. It is right in the groin. That is what they call a high and low saphenous vein ligation.

Q. Right in the groin?                      A. That is right.

Q. Now, do you recall after the operation seeing a bandage?

A. Yes. They always wrap the complete limb in what they call an Ace bandage.

Mr. Deasy: I move to strike out what they always do.

The Court: Mr. Wertheimer, I think we can proceed [26] a little more rapidly if you get Miss Canon just to answer directly the question. It saves a lot of time of all of us. All he asked you was whether you saw a bandage. Now, you can say yes or no to that, see what I mean? But instead you start to give a discussion as to what they always do. Now, that makes it difficult. I am explaining this to you so that you won't think I am arbitrary.

The Witness: I know.

The Court: It just makes it more difficult for the Judge to follow the evidence if you indulge in these



(Testimony of Myrtle Canon.)

general statements, because then I get led off the track of what the attorney is trying to bring out that is pertinent. So you can be helpful to us if you will just try to answer directly the questions and not volunteer anything.

The Witness: Thank you.

Q. (By Mr. Wertheimer): Did you see the bandage after the operation? A. Yes, I did.

Q. Can you describe it?

A. It was just the routine dressing that they put on for——

Q. (Interrupting): That is the kind of the thing Judge Goodman doesn't want you to do. Just tell us what you saw.

The Court: What kind of a bandage was it?

A. It was just the whole leg was bandaged in Ace bandage and the pressure bandages over the wound in the groin. [27]

Q. (By Mr. Wertheimer): The bandage extended then, did it, from the——

A. (Interrupting): From the toes to the thigh.

Q. From the toes to the thigh. Just a continuous strip of bandage. Was it on reasonably tight?

A. They always put them firm.

Mr. Deasy: I move to strike that out upon the ground—the question, your Honor, was whether it was reasonably tight.

The Court: He wants to know what you can tell us whether the bandage was reasonably tight, whatever that means.

(Testimony of Myrtle Canon.)

A. Yes.

Mr. Wertheimer: I will withdraw the question.

The Court: I don't see the pertinency of what kind of a bandage was on. Now, these details are really not getting down to the real question we have here and they take up an awful lot of time.

Mr. Wertheimer: Well, I have to, your Honor—

The Court: Well, you can take it for granted the Judge knows what it means when a person is operated on, but can't we get up to the point of where there was something developed that has some relationship to your claim here?

Q. (By Mr. Wertheimer): Do you recall having a fever after the operation, Miss Canon?

A. Yes. I was very miserable right after surgery.

Q. Did you feel any pain?

A. Yes, I did. I had terrific pain in the lower left quadrant of the abdomen.

Q. And what does that mean?

A. The lower left side.

Q. Did you have any pain in the leg as well?

A. The whole leg, but especially a lot of pain in the left side.

Q. Can you tell us when that began?

A. I was conscious of it as soon as I came out of the anesthetic.

Q. And did that pain continue?

A. Yes, it did.

Q. For how long?

A. Well, indefinitely, as far as I can remember.

(Testimony of Myrtle Canon.)

Q. Yes, but did you complain of pain?

A. Oh, yes.

Q. —To the nurses?           A. That is right.

Q. And to Dr. Rector?           A. Dr. Rector.

Q. You did complain to Dr. Rector of the pain?

A. Yes, I did.

Q. Did he give you sedation?           A. Yes.

Q. —for the pain? [29]

A. That is right.

Q. Now, did you, when was the bandage removed?

A. It was about the eighth or ninth day. I remember he took sutures out on that day.

Q. And you saw him do that?

A. Yes, I saw him.

Q. Now let me ask you this, Miss Cannon. Prior to his removal of the bandage, did you attempt to touch that wound in any way?

A. No, I didn't.

Q. With your fingers?

A. No. You couldn't, because the whole things was bandaged clear from your toes up.

Q. With any instrument did you?

A. Nothing.

Q. Did you at any time while you were in the Army hospital from the time you left until you went to the—to go to the University of California Hospital touch with your fingers or any instrument the wound or incision?           A. No, sir, I did not.

Q. —Or the ulcer?

(Testimony of Myrtle Canon.)

The Court: I think, Mr. Wertheimer, that probably we should take an adjournment at this time until tomorrow morning.

Mr. Wertheimer: All right, your Honor. [30]

The Court: We spent an awful lot of time in argument but it may be helpful in the final determination of the case.

We will take a recess until ten o'clock. [31]

Wednesday, March 23, 1949

The Clerk: Canon versus the United States.

Mr. Wertheimer: Ready.

Mr. Deasy: Ready.

Mr. Wertheimer: If it is agreeable to the Court and Mr. Deasy, I would like to call Miss Canon for a question or two and then interrupt her examination with that of Dr. Esnard.

The Court: Is the doctor here?

Mr. Wertheimer: Yes.

The Court: Would you like to put him on now?

Mr. Wertheimer: I thought I would just finish up a question or two with Miss Canon.

Thereafter,

### MYRTLE CANON

resumed, testified as follows:

#### Further Direct Examination

By Mr. Wertheimer:

Q. Miss Canon, I think you were testifying yesterday that you said you were bandaged with an Ace

(Testimony of Myrtle Canon.)

bandage from your ankle up to your groin, is that right?      A. That is correct.

Q. Now, did you at any time tamper with that bandage or touch the wound? [32]      A. No.

Q. You recall—do you have any recollection as to when the bandage was first removed?

A. As I remember it was on the eighth or ninth day.

Q. The eighth or ninth day?

A. Because it was at that time that he took the sutures out, I believe.

Q. At the time he took the sutures out?

A. That is right.

Q. Do you have any recollection whether prior to that the wound had bled?

A. I don't remember. I didn't glance at the dressing as he took it off.

Q. But during the eight or nine day period you had a temperature, did you?      A. Yes, sir.

Q. And you had pain?      A. Yes, sir.

Q. —In your leg, in the lower left quadrant of your abdomen, is that right?

A. That is right, yes, sir.

Q. Now, did you have a chance to observe the wound when he took the dressing off to remove the sutures?

A. Well, I just glanced at it when he took the sutures out and then he asked the nurse—I just glanced at it and [33] at a glance it looked to me as though the skin had just—wasn't together, and



(Testimony of Myrtle Canon.)

had separated, and I remember he made a statement to the nurse, he said, would you give me some adhesive butterflies, that is adhesive tape that they cut and put across a wound to hold it, to keep it from separating. He said I don't think that it will do any good.

Q. (Interrupting): Who did he say that to?

A. The nurse. He said, will you please give me some butterflies and I will put them on but I don't think it will do any good because I don't think it will hold.

Q. What are butterflies?

A. Butterflies are pieces of adhesive tape. They cut a little "V" and invert it and then they pull the skin edges together and put them across to hold the skin edges together.

Q. And then did he rebandage it? A. Yes.

Q. Was there anything else said on that occasion, do you recall?

A. I don't remember anything else being said.

Q. Now, was there another bandage applied?

A. Yes, he applied another dressing.

Q. And was an Ace bandage applied over that?

A. Yes.

Q. You continued to suffer pain, did you?

A. Yes, it began to get more extreme at that time. [34]

Q. It began to get more extreme and you complained about the pain? A. Yes, I did.

Mr. Wertheimer: I think before going into the details of the treatment of Miss Canon at the hos-

(Testimony of Myrtle Canon.)

pital further, I will put Dr. Esnard on, if I may.

The Court: Very well.

Mr. Wertheimer: Thank you, Miss Canon.

Thereafter,

DR. RAOUL ESNARD.

called, sworn, testified as follows:

The Clerk: Your name in full?

A. Dr. Raoul Esnard.

The Clerk: Please take the witness chair.

A. Thank you.

Direct Examination

By Mr. Wertheimer:

Q. Doctor, where are you living, Doctor?

A. In Los Angeles.

Q. And you are practicing medicine there?

A. Yes.

Q. Where were you—what is your age?

A. 48.

Q. Where were you—where did you get your medical education?

A. I graduated from the St. Louis University School of [35] Medicine.

Q. And you are licensed, Doctor, in the State of California? A. Yes.

Q. Are you affiliated with any hospitals in Los Angeles?

A. I am on the staff of the Cedars of Lebanon Hospital and the California Hospital.

(Testimony of Dr. Raoul Esnard.)

Q. The California Hospital, also known as the California Lutheran Hospital?

A. That's right.

Q. Now what, how long have you been in practice? A. Since, oh, 20 years, 1929.

Q. And what of your practice, was that all in California? A. Yes.

Q. And what has your practice been, what has your practice consisted of?

A. General practice with special attention to surgery.

Q. Special attention to surgery. Are you a Member of the American College of Surgeons?

A. Yes.

Q. Now, do you recall seeing Miss Myrtle Canon some time during January of 1948? A. '48?

Q. During——

A. (Interrupting): Yes, on the 29th of January.

Q. The 29th of January, and did you make an examination of her [36] at that time? A. Yes.

Q. Can you tell us what you discovered?

A. She had extensive swelling and inflammation with a large ulcer on the anterior surface of the left leg. The leg was quite swollen and she had numerous healed scars over both legs and the abdomen and chest. She had a draining sinus on the anterior surface of the abdomen just a little to the right of the umbilicus with three small sinus openings. She was running a temperature at that time and having

(Testimony of Dr. Raoul Esnard.)

—complaining of pain both from the leg and from the sinus tract on her abdomen.

Q. Did you take at that time any pictures of her?

A. Not at that time.

Q. But subsequently?

A. I never took any pictures, but one of the doctors in the hospital—

Q. But the hospital did. You have those with you, have you? A. Yes.

Q. Did you make any effort to determine what it was that was wrong with her?

A. I established a diagnosis that *she thrombo phlebitis* with a cellulitis of the leg, of the left leg.

Q. And what did you call that? [37]

A. A thrombo phlebitis with cellulitis of the left leg and then this draining ulcer on the abdomen. She was hospitalized and both conditions were treated.

Q. Now, what treatment did you give the leg?

A. Leg elevation, ice, antibiotics and what we call a perivertebral block which tends to relax the blood vessels on the leg. An antibiotic dressing to the ulcer and cellulitis of the leg. It responded to treatment. The ulcer—the cellulitis subsided and the ulcer healed.

Q. That is in the leg? A. That is right.

Q. Now, pursuing—is that—was that the extent of your treatment of her left leg?

A. Well, from time to time the leg would flare up and become painful and swell, particularly if

(Testimony of Dr. Raoul Esnard.)

she was ambulatory at all, but only on two occasions did she, that I can recall, that the pain became very severe in the leg. There has always been some swelling in the left leg, which has been larger than the right leg as I have seen it.

Q. Has been what? A. The left one.

Q. I didn't hear that word, Doctor.

A. The left leg has been larger than the right leg.

Q. Now, did you give any treatment to the ulcer that I think you described was in the abdomen at that time? [38]

A. Yes, many and various things. We excised it, debrided it and ultimately did skin grafts. We excised the involved area and let it granulate. The last time I excised the involved area and closed it by a primary closure, a portion of it subsequently broke down. Now she has a persistent sinus tract that has extended up on the right side of the abdomen and up to the chest.

Q. That is something that she has at the present time? A. Yes.

Q. Do you recall, did she require any drugs to build up her resistance?

A. Well, she had numerous transfusions and she received massive doses of penicillin, streptomycin, and we tried x-ray therapy on it and then topically I was able to get some vasatracin, that is one of the recenter antibiotics that is applied locally and a zinc bioxid and penicillin solution applied locally



(Testimony of Dr. Raoul Esnard.)

and scarlet red and anything else we could think of. At the moment we are using penicillin powder directly on the wound.

Q. Do you recall off hand how many transfusions she has had since she has been in the hospital?

A. I think about 12 or 13, her last one——

Q. You spoke of operations of the ulcer. How many operations? A. Ten.

Q. Requiring a general anesthetic? [39]

A. Ten.

Q. Was she in pain, incidentally, from the leg while the ulcer——

A. (Interrupting) Both.

Q. Did you make any diagnosis as to what this ulcer was?

A. It was a mixed infection. We were able to isolate and identify a micro-aerophilic strep as described by Melony which is characterized by a type of lesion that she has on her abdomen.

Q. Is that known as a kind of a phagogenic ulcer—— A. That is right.

Q. Which means a burrowing or undermining ulcer? A. That is right.

Q. Now, your diagnosis of that was based on a behavior of the ulcer and the isolation of this micro-aerophilic strep. Did you isolate any other bacteria?

A. A culture of the surface of one of them did give us a primary puiosziamious, a staff puiosziamious which was the most consistent secondary infection that we had to deal with.

(Testimony of Dr. Raoul Esnard.)

Q. Is the micro-aerophilic strep a deep burrowing one?

A. Yes, it is one that grows best where there is little or no oxygen. It burrows into the tissue. That is why a topical antibiotic is not very effective.

Q. What does that mean, a topical? [40]

A. Things you put on the wound.

Q. So that would you say that—what was the zinc bioxide treatment, for the purpose of attacking that particular disease?

A. It replenishes the oxygen in the tissue and of course the aerophilic strep doesn't do well in the presence of oxygen and it tends to inhibit the growth of the bacteria.

Q. Is this type of infection characterized by hemorrhage, Doctor?

A. All strep infections are characterized by serro sanguinous types of drainage. In this particular case where small blood vessels are eroded you can have extensive and quite frequently some bleeding.

Q. Now, did you ever notice whether her bandages were blood soaked?

A. Practically always there was some drainage on the dressing.

Q. Did you—did you ever find any evidence, Doctor—let's see, I take it that in the year she has been there to the best of your belief, with all of your efforts the ulcer has continued burrowing and undermining?

A. That is right.

(Testimony of Dr. Raoul Esnard.)

Q. Did you ever find any evidence, Doctor, that she herself was tampering with that ulcer?

A. No.

Q. Is there anything in the nature of that infection that [41] would indicate to you whether its continuance and progress was caused by her tampering?

A. No.

Q. Well, did you have—is there anything in the infection or its progress or the way in which it looks that indicates that its forward movement or aggressive action, its continuance wasn't caused by tampering?

A. Would you repeat that, please?

Q. I will make it a little clearer. Is there anything about the way the infection behaved and the way it advances as determined by your observations, surgical or otherwise, that indicate that this kind of infection and its progress is not caused by self tampering?

A. That is correct. It isn't caused by self tampering.

Q. Well, what is the basis for your saying that, what is it about it that makes you say that?

A. One of the most significant things is the character of the tissue around the ulcer. When the wound is excised part of the tract is excised widely, as much as three or four centimeters from the tract itself and you can find all of the blood vessels, both the arteries and the veins thrombosed. That is, the lumen is closed by clots which means that the infection is away beyond the sinus tract and in order to

(Testimony of Dr. Raoul Esnard.)

cure it, you have to excise so widely that you normally take out all of the sinus tract, being the little blood vessels [42] along which the infection travels.

Q. Those were ones which weren't reached by any instrument?

A. Of course not; it couldn't possibly be.

Q. Couldn't possibly be. Now, has there been—withdraw that. This fever that she has had, has that been consistent or——

A. Well——

Q. Interrupting): ——constant or occasional?

A. Whenever the wound drains, well, she has a little running of temperature.

Q. You mean with this bloody serro sanguinous discharge, is that what you are referring to drains?

A. That is right.

Q. Did you take any, or any staff doctor there take any, photographs of her abdomen?

A. One of the doctors on the staff did.

Q. Do you happen to have that or do you know when they were taken?

A. I can't say exactly. They were taken several months ago. Two or three months, perhaps.

Q. About two or three months ago. These show two or three abdomens. Did she have additional scars on her back?

A. I don't think so at that time. I subsequently—those pictures show a small area of ulceration which extend away posterially under the skin. [43]

Q. Yes.

A. ——And subsequent to that picture they were excised so for a time it extended way back.

(Testimony of Dr. Raoul Esnard.)

Mr. Wertheimer: I offer these in evidence.

Mr. Deasy: We have these DeWitt Hospital records entered into evidence as Exhibit 3, is that correct?

Mr. Wertheimer: Yes.

Mr. Deasy: Then these pictures would be 4 and 5.

Mr. Wertheimer: DeWitt or Tormey?

Mr. Deasy: These are separate, these are DeWitt records.

Mr. Wertheimer: Yes.

Mr. Deasy: I understand those pictures, Doctor, were taken the early part of this year 1949?

A. No, I am sure they were taken late last year.

Mr. Deasy: Late in 1948?

A. Yes. I can't recall exactly when they were taken.

Q. (By Mr. Wertheimer): Now, can you describe to us, Doctor, what the present condition of Mrs. Canon is?

A. Well, she has an impairment of the circulation of her left leg with the associated swelling and pain and she has a progression of the original infection of the abdomen which will have to be excised again. We hope this time we might be able to get it all and get a primary union.

Q. Well, does her leg swell? [44]

A. Yes.

Q. Now, with respect to this ulcer, is there any certainty that you can cure her of this ulcer that has persisted for four years? A. No.



(Testimony of Dr. Raoul Esnard.)

Q. But you are still hopeful and you are still trying, is that right? A. Yes.

Q. Is she in condition to do any work?

A. No, certainly no work that involves standing on her feet or walking.

Q. Is she getting medical care at the present time?

A. Yes, she is getting some pain medication and as I say penicillin locally.

Q. And what about the dressings? Are they being changed?

A. Since she has come up to San Francisco I think the Army changed them once and I hope to change them before I leave. They should be changed frequently though.

Q. What about—what was the last transfusion that you gave her?

A. I think that was Friday of last week.

Q. Is it possible or likely that—is it likely she will receive transfusions in the future?

A. She should have more before her next surgery.

Q. This sinus you spoke of is still draining? [45]

A. Yes, and extending.

Q. On her right side.

The Court: This phlebitis has been arrested, has it not?

The Witness: Well, at the moment she has just the result of impairment of circulation in the leg.

The Court: That is residual.

(Testimony of Dr. Raoul Esnard.)

The Witness: No interference with the circulation. Of course, she has had flare-ups of phlebitis. The actual inflammatory process has recurred.

Q. (By Mr. Wertheimer): Was that condition she had in her leg a consequence of this infection in any respect, or the treatment of the infection?

A. I understand that, of course, originally the saphenous ligation and then the extensive hospitalization and excising some of the veins in the leg with the natural direction of the red supply available, plus the infection that existed in that area were all contributory to her present impaired circulation.

Q. In other words, the thrombo-phlebitis is not something as far as you know she had before all of this occurred, it is a consequence of the treatment that she had?

A. Yes, in all probability.

Q. Now, Doctor, let us assume that Miss Canon was operated upon on June 14, 1945, and thereafter commencing within a [46] day and for a period of six or seven days she ran a low grade temperature, no higher than 101 and ranging from 99 to 100 or 101 following the operation, would that be an indication of infection?      A. Yes.

Q. And if in addition to the temperature she complained of pain in her leg and in her lower, the lower left quadrant of her abdomen, would that reinforce your answer, would that also indicate infection?      A. Yes.

Q. And now, if in addition to that she, on the

(Testimony of Dr. Raoul Esnard.)

9th, on or about the ninth day following the operation, the wound broke open and exuded a sanguinal serros material, would that be a further indication of infection?           A. Yes.

Q. Would you say it was a bad medical practice in accordance with the way medicine was practiced in the State of California in 1945 not to recognize that those symptoms indicated infection?

A. Yes.

Q. And would you say, Doctor, that if the symptoms that I have described occurred that a failure to make a culture of the sangrenal currus exudate which commenced on or about the ninth day following the operation was bad medical practice and negligence? [47]           A. Yes.

Q. Would you say that the presence of the low grade temperature for a period of two or three or four days following the operation was an indication of infection?

A. Low grade, meaning what?

Q. Well, from 99 to 101 plus.           A. Yes.

Q. Now, with the symptoms that I have just described to you present, the persistence of the temperature at that approximate point for the period indicated and the exudation of the sanguinous serros material and the existence of pain in the patient's leg, would you say that good medical practice would have at that time and in this State prescribed the use of sulpha, some compound of sulpha or penicillin or both?           A. Yes.

(Testimony of Dr. Raoul Esnard.)

Q. Would you say it was bad medical practice in those circumstances and negligence not to have prescribed one or both of those drugs?

A. Yes.

Q. And if, Doctor, a culture had been taken from the sanguinal serros exudate on or about the ninth day after the operation and it disclosed a hemolytic staphylococcus orios that would have very clearly indicated that the wound was infected, isn't that right, Doctor? [48]

A. Yes.

Q. And you would say that it was negligence and bad medical practice at that time and in this State not to have taken steps at that time to arrest the infection with the use of penicillin or streptomycin or sulpha?

Mr. Deasy: I object to that upon the ground it is leading and suggestive and also as complex and indefinite as to the time he is referring to.

The Court: I think it is.

Mr. Deasy: I can't understand the question at all.

Mr. Wertheimer: Withdraw the question, withdraw the question.

The Court: The last is objectionable, I think.

Q. (By Mr. Wertheimer): You are familiar with the use of—as a doctor, with the use of sulpha compounds and penicillin?

A. Yes.

Q. Is that correct, and now is it not—is it your opinion that if an infection is discovered to be present that it is poor medical practice not to give one

(Testimony of Dr. Raoul Esnard.)

or both of these drugs earlier in adequate quantities?      A. Yes.

Q. And it is a fact, is it not, that if there is—if the administration of a sulpha compound or penicillin is delayed the organism causing the infection would have a chance [49] to become better established and more difficult to deal with later?

A. Yes.

Q. In fact, the patient may develop a drug fastness, in other words, if the drugs would have been administered earlier it would have controlled the infection but then becoming later become unavailing, isn't that correct?

A. Well, you can only develop a drug fastness after having received the drug, but it is the bacteria that develop the resistance to the drug if given in small quantities.

Q. Well, my question may have been misleading, and what I wanted to say was this: that it is bad medical practice not to give these, I think you have testified, to not give these drugs early when infection is present, isn't that correct?

A. Not to, yes.

Q. Yes. Now, with relation to the question of the adequacy of the amount given, it is a fact, is it not, that if drugs when first given, a sulpha compound or a penicillin, when they are not given in adequate quantities the bacteria tend to become resistant?      A. Yes.

Q. So that the proper dose and the proper medical treatment is early and adequate dosage?



(Testimony of Dr. Raoul Esnard.)

A. That is right.

Q. And it is negligent not to give this treatment where an [50] infection is present, isn't that correct, Doctor?

A. Yes.

Q. Now, if, Doctor, an incision was made into this wound, the wound in the groin on July 13, 1945, and it indicated and there was present a chronic inflammation or a cellulitis, a fatty necrosis of tissue, would that have been some indication that the infection had persisted since surgery?

A. Yes.

Q. And would it be any indication to you of the kind of infection she had?

A. Well, the character of the drainage would suggest the type of infection that she had.

Q. Would you mind explaining that a little bit?

A. Well, certain bacteria produces pus which is somewhat characteristic of that particular strain. *Pseudomonas* produces a greenish pus. *Colon bacillus* produces an offensive smelling pus, foul smelling, and *streptococcus* produces a bloody watery type of exudate, so that would certainly indicate the type of infection that you might be dealing with.

Q. In other words, the absence of pus in the early stage wasn't evidence that there was no infection?

A. No, sometimes you don't have pus at all in the infection.

Q. And the bloody exudate indicating a *streptococcus* type of infection—

(Testimony of Dr. Raoul Esnard.)

A. (Interrupting): It suggests that type. [51]

Q. Now, if a micro-aerophillic streptococcus were found by a culture would that be indicative that there was a phagogenic ulcer?

A. Well, I don't know whether all phagogenic ulcers are caused by micro-aerophillic strep, I don't know whether that—identifying that organism would necessitate an ulcer, but where an ulcer exists and that particular strep is isolated, then you can conclude that you are dealing with a phagogenic ulcer.

Q. And in your opinion what effect would the administration of one of the sulpha drugs or, and/or a penicillin with a week of ten days from the operation, what effect would that have had upon Miss Canon's infection in this case?

The Court: You are asking the doctor now to——

Mr. Wertheimer (Interrupting): It is his opinion.

The Court: ——to take the place of God.

Mr. Wertheimer: It is only an opinion, your Honor.

The Court: Of course, he can tell you what the statistics are or what has happened within his time, but he couldn't tell you in any particular case what the effect of the administration of any drug would be unless he was there and knew all of the conditions at that time, isn't that correct, Doctor?

The Witness: That is right, your Honor.

(Testimony of Dr. Raoul Esnard.)

Q. (By Mr. Wertheimer): Well, in your opinion, would——[52]

The Court: What you are asking him is good medical practice to administer these drugs under the conditions. He states that is right, and he has already told you that it is, it is good medical practice, and I assume that is true because of the fact that it produces generally good results, isn't that right, Doctor? A. Yes.

Mr. Wertheimer: I think he has gone farther than that. I think he has said it was bad medical practice not to have done so and negligent not to.

The Court: The United States Attorney didn't object to it, but he couldn't say that was negligent. All he can say is that it wasn't in conformity with the recognized medical practice at the time.

Mr. Wertheimer: That is right. I realize that that is the ultimate question to be decided by your Honor.

Q. Can you say, Doctor, whether there was anything about this particular infection that would have indicated one way or another whether it was produced by self infliction?

The Court: He has already answered you on that, Counsel. He told you there was no evidence of that. You are back-tracking now and going over the same ground.

Mr. Wertheimer: I think it is a little different question, your Honor, but I guess that takes care of it. Doctor, do you have an opinion—well, withdraw that. [53]

(Testimony of Dr. Raoul Esnard.)

Q. Let us assume, Doctor, that prior to the operation Miss Canon was free from infection and that following the operation she displayed the symptoms of infection. Do you have an opinion as to what caused—what is your best opinion as to what caused the infection?

Mr. Deasy: I will object to that, your Honor, first on the ground that there is no evidence that prior to the operation she was free from infection.

The Court: Yes. She has already testified to that. I don't think the question is subject to that objection but again I think he is asking the Doctor to play the part of God, as I put it. How could he possibly tell what was the cause of this. He wasn't there and he didn't see it.

Mr. Deasy: I will object to the question on the ground it is speculative also, your Honor.

The Court: Well, I think it is objectionable on that ground.

Mr. Wertheimer: Well, all right.

Q. Doctor, do you have an opinion as to whether or not this infection was caused by contact of the wound or incision with some contaminated object?

The Witness: Your Honor, I mean obviously that had to be the explanation of it, but what and how——

The Court (Interrupting): Couldn't an infection develop for other reasons? [54]

A. There is one other reason. If a person has a few bacteria and that frequently does occur in

(Testimony of Dr. Raoul Esnard.)

the blood stream, that might settle in an area that had been traumatized, but that is extremely unusual.

The Court: Are you saying that the only way that an infection can develop in a person that has been operated on is because of some contaminated instrument or other object being brought in contact with it?

A. I think perhaps unless it is a sterile abscess where——

The Court (Interrupting): Don't people develop infections countless times after operations that result from conditions in the body of the person and have nothing to do with the use of instruments or any other evolvment of that?

The Witness: Not where bacteria are involved. I mean, you have to have bacteria and they have to get in there some way, your Honor. Now, a sterile abscess, we know for instance that some people are allergic to catgut. You use catgut to sew them up and they will get quite a violent reaction around the suture and the wound will drain and just as soon as the catgut is excluded from the wound the wound heals.

The Court: Well, suppose the patient has some other condition at the time.

The Witness: In diabetes—— [55]

The Court: ——exacerbated by the wound plus an infection——

The Witness (Interrupting): You have to have



(Testimony of Dr. Raoul Esnard.)

the bacteria in there. They have to get into the wound.

The Court: I see.

The Witness: If they had diabetes, it would make them more susceptible to the infection or in anemia. They are contributory things.

The Court: But your testimony is that in infection that—where there are present the type of bacteria you mentioned it can only be produced by—as a result of some contamination?

The Witness: Or—it would be in the blood stream which, as I say, is extremely unlikely.

The Court: You mean an infection already in the blood stream?

The Witness: That is right.

The Court: That is to say a streptococcus infection already in the blood stream?

The Witness: In the blood stream, and then it would settle in that particular place. The bacteria——

The Court: In other words, a person could have, say, a diseased tonsil which would also produce a blood stream infection, it might?

The Witness: Then they would have to have septicemia.

The Court: Then they would have to have some other evidence to cause that? [56]

The Witness: Yes.

The Court: Does that cover about what you want?

(Testimony of Dr. Raoul Esnard.)

Mr. Wertheimer: I think it does, Judge.

The Court: All right. Well, while I have been asking these questions, may I ask you your interpretation of another question? Now, a phlebitis is what, what is its character?

A. It is characterized by an inflammatory process in the line of the vein with the resulting clot of the blood in the vein and the impairment in circulation.

The Court: Now that, is that ever from a traumatic infection?

A. Well, there are a good many arguments about that. I mean——

The Court (Interrupting): I have heard some of them, that is why I am asking.

A. If after a trauma they develop a phlebitis that is something that is remote to the area involved.

The Court: Ordinarily, however, a phlebitis is a disease that develops irrespective of trauma, is that right?

A. Trauma alone is not the cause of it. It may, however, be caused as I say when you inject the vein in treating a varicose vein you bruise the lamina.

The Court: That would be a means of bruising it?

A. Yes.

Q. (By Mr. Wertheimer): And if a radical sauserization has been performed in that area; that would likewise be a [57] cause of phlebitis?

(Testimony of Dr. Raoul Esnard.)

A. Well, you see so many of the veins were ligated apparently, of course I wasn't there so I can't tell how much was done, but the scar indicates a good deal of the vein, the superficial part of the saphenous vein was excised and since the most of the circulation to the leg comes from the femoral artery and vein and since the involved area was right over that, there must have been some interference with the femoral vein and its collateral circulation, so that even if the vein was completely closed you could gradually establish collateral circulation. I believe it depends on the location of the——

The Court (Interrupting): Are there any other questions now, Mr. Wertheimer?

Q. (By Mr. Wertheimer): Doctor, is it generally known that a fatty person is more susceptible to surgical infection than one that is not?

A. Well, fatty tissue doesn't have the resistance of muscle, of muscle for instance, so that particular type of tissue is more susceptible to infection, it doesn't have the resistance.

Q. Well, what I am getting at is Miss Canon weighed, I think, at the time of the operation 192 pounds, and a prudent surgeon would and should recognize that infection is more likely to spring up following an operation on such a [58] person than a person of average weight.

A. But that isn't a contra indication, I don't think, for surgery.

(Testimony of Dr. Raoul Esnard.)

Q. Not a contra indication for surgery, a lot of fat people have surgery but——

A. (Interrupting): It makes it more difficult.

Mr. Wertheimer: I think that is all at this time.

The Court: We will take a brief recess and then you may cross-examine.

(Short recess.)

Mr. Wertheimer: I think I have concluded my direct examination.

Mr. Deasy: Just a few questions, Doctor.

#### Cross-Examination

By Mr. Deasy:

Q. You have no personal knowledge of the condition of Miss Canon—of this infection of Miss Canon's prior to January, 1948? A. No.

Q. That is when you first observed her?

A. When I first saw her, January, 1948.

Q. And at that time the ulcerated area was confined to the right side of the abdomen, is that right?

A. The right side, yes.

Q. And there were no—there were no draining sinuses other than in the place you have indicated?

A. That is right.

Q. Nothing on the left side or——

A. (Interrupting): Well, there was this ulcer on the anterior surface of the left leg with the associated cellulitis which I don't think had any-

(Testimony of Dr. Raoul Esnard.)

thing to do with the, that phagodenic ulcer we are talking about. It was——

Q. (Interrupting): That was attributable to the phlebitis?

A. From the phlebitis, yes.

Q. Well, let me ask you this, when there is—when there is surgery performed such as a ligation of the veins for the reduction of—well, such as was performed in this case, would you anticipate that there is a likelihood, or is there a likelihood, of a phlebitis developing from surgery upon the veins and the blood vessels?

A. You actually produce a sterile phlebitis. I mean, you close off the vein. The vein then becomes plugged and a clot forms in it and it eventually atrophies. A thrombo-phlebitis is primarily on an inflammatory basis. You don't have—you have a little discomfort when a vein is tied off, but when you have this inflammatory process then you have considerable pain and considerable swelling. Of course there is some swelling in the ligation, that is why they put an Ace bandage on, to support the circulation until it is re-established.

Q. In a ligation such as was performed on Miss Canon in [60] this case in June of 1945, certain swelling and pain at the site of the operation is to be anticipated, isn't it?

A. Well, no——

Mr. Wertheimer (Interrupting): Just a moment, if it please the Court. The record in this



(Testimony of Dr. Raoul Esnard.)

case—the record of this case discloses this, your Honor: that there was pain immediately following the operation but the record does not disclose that following the operation there was swelling. Measurements were taken as will appear——

The Court (Interrupting): I don't think that Counsel was asking the question directed particularly to this operation. If I heard you correctly, he wants to know whether or not a ligation of this kind, whether it wasn't normal—whether it was or was not normal that there would be pain and swelling resulting.

Mr. Deasy: Yes, your Honor.

Mr. Wertheimer: Well, your Honor, I don't want the question to be misleading. I want the facts understood and what ranges the questions have to them.

The Court: I will allow that. It is proper cross-examination.

The Witness: With any incision into the skin, there is some pain and not necessarily swelling, but the pain is transitory. In a day or two you have just a little discomfort and no more. [61]

Q. (By Mr. Deasy): Now, with reference to an infection at the site of an operative wound, is it more likely, Doctor, an infection would develop shortly after the operation or after some period of time?

A. Well, it depends on the type of infection. The more virulent infections develop early and the

(Testimony of Dr. Raoul Esnard.)

less virulent ones develop quite late. The incubation period is longer in the less severe or less virulent ones so it would vary with the type you were dealing with.

Q. What I really had reference to was the likelihood of bacteria entering the wound to cause the infection. Is it more likely shortly after the operation than after the healing process has commenced, isn't that so?

A. Well, potentially the wound—if you are dealing with an infected wound, potentially it is infected from the time of the surgery, at the time that the bacteria are introduced in to the wound. The manifestation of that infection varies with the type of bacteria that you are dealing with. Is that clear, your Honor? Have I answered his question?

The Court: I think so. I don't know precisely, but the attorney will carry on.

Q. (By Mr. Deasy): You stated in your direct testimony as I gathered that it was your opinion as of now that the infection in this kind of case got in there to the wound at the time of the operation and not later? [62]

A. Well, that is a reasonable presumption.

Q. And you mean at the very moment of operation, is that right, or would you say within 24—

A. (Interrupting): Not at the moment, during the course of it, I beg your pardon.

Q. Would you say within 24 hours?

A. No, at the time of. I mean the operation may

(Testimony of Dr. Raoul Esnard.)

have taken a half to three-quarters of an hour. During that time. You see bacteria will develop latently. They don't come out of thin air. They have to get in there and begin to grow and multiply. It is their growth and multiplication that gives you the infection.

Q. I think that you stated that it would be necessary for them, for the bacteria, to appear in the wound, that they should come either from the blood stream or from the contact with some contaminated object.

A. Yes. Ordinarily suture material is a most common sort of wound infection.

The Court: You mean bandages?

The Witness: No, the material you use to tie off the blood vessels. It is——

The Court: You mean the gut or whatever is used ?

The Witness: The gut or whatever was used.

Mr. Deasy: Gut was used in this case, your Honor.

The Witness: But I mean a pair of gloves that weren't [63] thoroughly sterilized. A surgeon might prick his finger—I mean prick his glove with a needle and if there were—was bacteria on the skin and it got on the needle, I mean there is an infinite number of ways.

The Court: Well, the doctor might be the most cautious and experienced doctor and still there might be infection?

(Testimony of Dr. Raoul Esnard.)

The Witness: Oh, sure, because he has to depend on the orderly that runs it, the autoclave in the dressing room or the sterilizing room and has to depend on the people who make the suture material and the catgut. In other words, the most cautious doctor might find himself confronted with infection if the people that manufacture the suture material have been careless in some way and there was no way of determining it, he couldn't tell.

The Court: So that there are innumerable ways in which in the course of an operation that infections could result, even in the case of the most prudent doctor?

The Witness: That is correct, it does happen in the case of most prudent doctors.

Q. (By Mr. Deasy): I was about to ask you, Doctor, if it isn't a fact that post-operative infections of one kind or another are not extremely rare?

A. Well, do you mean today or in the last 40 years?

Q. Well, I am not referring to 40 years ago, say within the [64] last five years.

A. They are certainly becoming less frequent and less severe.

Q. But here is the possibility after the operation of some infection developing, isn't that so?

A. Oh, sure.

Q. And no matter how cautious they are?

A. I personally routinely use a prophylactic

(Testimony of Dr. Raoul Esnard.)

penicillin with all of my cases immediately after surgery, just in case one little bug that might have gotten in don't get a chance to grow.

The Court: You mean you use it now?

A. I use it periodically and hypodermically 300,000 units a day.

Q. (By Mr. Deasy): Now, as I understand it, in the case of Miss Canon here shortly after the operation, that is, within a day or so, she developed a pain at the site of the wound and that at the time the sutures were removed, which I understand from her testimony was about eight days after the operation, she observed an exudate of some kind on the bandage, and that the wound at that time appeared to be—to have opened somewhat?

A. A little opened.

Q. To have opened up? A. Yes.

Q. I am not quite clear as to whether that was before or [65] after the sutures were removed, but it was about that time she observed that?

A. Well, I of course wasn't there.

Q. Does the record show?

A. I was going to say presumably when the sutures were removed.

Q. Well, it opened up.

A. Yes, rarely does it occur before that. Sometimes, but they don't pull out so easily.

Q. Now, you stated that at that point, Doctor, it would have been good medical practice to have taken a culture of the materials which had exuded



(Testimony of Dr. Raoul Esnard.)

from the wound, the fluid which had exuded from the wound.       A. Yes.

Q. And that it was bad medical practice not to take a culture of that exudate right away?

A. Yes.

Q. I think you also stated that both on the complaint of pain by Miss Canon and the evidence she was running a low fever, that it was good medical practice to prescribe medication in the form of sulpha or penicillin or both?       A. Yes.

Q. Now, isn't it a fact, Doctor, that among medical men there are two schools of thought on that point? Many doctors practicing in the State of California do not immediately [66] prescribe drugs, but they use medication in the form of dressings at the site of the wound?

A. Of course, I am prejudiced, your Honor. I use it before they ever get an infection.

The Court: Would you know if there are two schools of thought?

A. I haven't heard of the school that doesn't take advantage of the antibiotics and the sulpha drugs.

Q. (By Mr. Deasy): You personally in your own practice prescribe the use of the drugs?

A. Penicillin.

Q. Yes. I think you stated that you used it.

A. Prophylactically.

Q. And practically automatically?

A. Prophylactically, that is right.

(Testimony of Dr. Raoul Esnard.)

Q. Now, would you say then that doctors who do not prescribe sulpha or the sulpha drugs or penicillin immediately upon a complaint of pain and the evidence of a low fever following an operation are not following good medical practice?

Mr. Wertheimer: I think there is another factor here, your Honor, and that is the exudation of the sanguinal serros material.

The Court: He is not talking about that now.

Q. (By Mr. Deasy): I am speaking of, Doctor, the first eight days. [67]

A. Within the first eight days, yes. It isn't good medical practice. During the first two days there is a differentiation between the temperature. That normally and quite frequently normally occurs following the surgery. The pain of the surgery and the actual trauma could cause pain, but when the temperature persists and the pain persists, then the presumption is that there is something abnormal there and the most reasonable explanation would be an infection, and if there is an infection then the patient should receive everything at our disposal to counteract the infection.

Q. It is true, is it not, Doctor, that there are many persons who are, well, you might call it allergic to the antibiotic drugs? A. Yes.

Q. And with such persons how could you determine whether or not a person were allergic to, say, penicillin or the sulpha drugs?

A. They usually develop a rash or they develop

(Testimony of Dr. Raoul Esnard.)

hives. They usually get a local reaction at the point of administration of the penicillin. They get an angella neurotic edema. They can't have asthma. They can develop that if it is due to an allergy, then they can develop any of the allergies from the penicillin.

Q. But it is good medical practice, I understand you to say, to administer those drugs and then determine after the [68] administration whether or not a person is?

A. It is the only way you can find out whether they are allergic to them.

Q. Unless of course, a doctor knows from the statement of the patient or from a previous experience that the patient is allergic to those drugs?

A. Oh, yes, I mean—but they have had at one time or another an opportunity to determine.

Q. Now, Doctor, if Miss Canon shortly after the operation had, say, within the first 24 hours, had handled the bandage at the site of the operative wound or touched the wound itself, could the infection which later developed be caused by that, assuming that she had handled the bandage or wound?

A. Of course, that would be one way of getting an infected wound.

Q. Or, assuming that some hours after the operation, that is, the evening of the day on which the operation was performed, she got out of bed and wandered about and left the ward and went

(Testimony of Dr. Raoul Esnard.)

outside the ward and walked about in the hospital premises and did such—would such activity have resulted in an infection getting into the wound?

A. No. We acknowledge that early ambulation is the very finest treatment for most of these cases of surgery, I mean, surgical—

Q. (Interrupting): I don't mean the walking around, I mean [69] the exposing of herself to the air outside of the ward.

A. It is the same air.

Q. You feel that the air is not one of the contaminating objects that you would get bacteria into the wound from, is that right?

A. Well, air is one of the sources of contamination, surely. Lister used to operate in the operating room with a fan on thinking that was the greatest source. It is considered very unlikely though because you see in the ordinary—the course of the ordinary operation, an instrument will be lying on the instrument table for several hours and no attention made to sterilize the air in the room. Bacteria conceivably could settle on an instrument, but I think there has been—

Q. (Interrupting): You feel it is very unlikely, is that what you mean?      A. Yes.

Q. —that these bacteria would be air borne?

A. It is extremely unlikely. There is, of course, that possibility, but the fact that she left the yard, the confines of the yard, wouldn't be a factor particularly if the wound were dressed.

(Testimony of Dr. Raoul Esnard.)

Q. You are assuming that the bandage was properly attached to the wound and that would in itself keep any airborne infection from getting in?

A. That is right.

Q. I think you stated, Doctor, that at one time or another you took cultures from the present site of the ulcer and that as far as the cultures showed something which I tried to get and I think you spelled it, but you spelled it too fast. What was that?

A. Or not very well, perhaps. It was puyoszia-mious, p-u-y-o-s-z-i-a-m-i-o-s. Is that how I spelled it before? It is a type of infection that produces a green pus. I mean you can identify it purely by the appearance of the pus.

Q. Is that a separate organism or is that a type of stapholococcus or a streptococcus or what is it?

A. It is one of the stapho organisms. You see, auereus produces a whitish pus or in this particular strain a greenish pus.

Q. And that was found on the, more or less on the surface?      A. Yes.

Q. And I think you said that the depths of the wound or in the depth of the ulcer there was an micro-aerophilic streptococcus infection?

A. Yes, we were able to isolate it.

Q. And now I believe you said that since you have been treating Miss Canon you have had occasion to excise the ulcerated area?      A. Yes.



(Testimony of Dr. Raoul Esnard.)

Q. And that you have used the zinc peroxide treatment? [71] A. Yes.

Q. That is in the form of an irrigation, is it?

A. Yes, we use both a paste and an irrigation. We use a liquid and the paste.

Q. The paste is placed on the dressings and packed on the wound, is that it, or what?

A. When there is a sinus tract we introduce it catheters into the sinus tract and let it drip down into there in the liquid form.

Q. Is that the usual and proper treatment for a micro-aerophilic infection?

A. Well, Dr. Melony recommends it. It is such a rare infection that there is no usual and acceptable treatment.

Q. Is that Dr. Frank L. Melony of Columbia University? A. Yes.

Q. And is he an authority on ulcers, doctor?

A. He apparently was the one who first described this particular type.

Q. A phagogenic ulcer, you mean?

A. Yes. Or if he wasn't the first, he did a good job of describing it.

Q. And his recommendation for treatment is the use of zinc peroxide, is that right?

A. That is right.

Q. Now, I understood you to say, Doctor, that a future operation [72] was in order for Miss—for the treatment of Miss Canon?

A. That is right.

(Testimony of Dr. Raoul Esnard.)

Q. You hoped that the spread of the ulcer might be stopped?

A. With the last one, we, I think, accomplished more than in any of the previous surgeries. I hope to change technique sufficiently at this time so that we might be able to excise the involved area and get the primary union.

Q. The only thing that can be done is an excision of the areas, is that right?

A. Well, that is one of the accepted treatments.

Q. Apparently she has been—there has been many excisions performed upon this ulcer since the first?

A. Yes, before I took care of her.

Q. You found evidence on examination that several areas had been excised?

A. Yes.

Q. Numerous areas?

A. Yes, denuded.

Q. Wouldn't it be true, Doctor, that if and after numerous excisions were performed upon this ulcer and that it nevertheless continued to spread in the face of irrigations with zinc peroxide and dressings with zinc peroxide and dressings of medication by means of penicillin and streptomycin and sulfa drugs, and nevertheless it continued to spread, wouldn't that be an indication that the wound was being reinfected [73] from time to time and new infection, new bacteria were getting in there?

A. Well, not necessarily because it would be hard to conceive of it being reinfected time after

(Testimony of Dr. Raoul Esnard.)

time always with the same infection. The thing is so rare to begin with and then you reinfect it every time with this very rare organism, it just doesn't seem possible, plus, of course, the findings when you get in there and see a type of infection that she does have.

Q. The particular organism you were just referring to is the micro-aerophilic strep?

A. Yes, that one can be controlled fairly easily. We are using a penicillin powder on it.

Q. The staphylococci infections are rather easily controlled?

A. They are more easily controlled.

Mr. Deasy: No further questions.

#### Redirect Examination

By Mr. Wertheimer:

Q. Will you tell us how much the infection has spread since you have been treating Miss Canon, Doctor?

A. From just a little to the right of the midline over the remainder of the abdomen, it started to go down the left leg. We apparently have been able to check the progress down there. It extended into the back and by excising widely and doing a primary closure, we have gotten a healing of the [74] back but over the crest of the ilium she has an ulcer now that extends upward so that is the extent of it today.

Q. Is this phagogenic ulcer, Doctor, produced by

(Testimony of Dr. Raoul Esnard.)

the sinegesture or cooperative action of more than one bacteria?

A. Apparently. I don't know. I don't think anyone knows too much about this kind of a thing. I certainly don't know enough about it to cure her.

Q. By the way, did you ever render a bill to Miss Canon in this connection, Doctor?

A. No.

Q. What do you estimate the reasonable value of your services for the past year to be, for the purpose of this lawsuit?

A. I haven't figured it out, but on the basis of \$5 for hospital calls and perhaps \$150 for each surgery, it would amount to quite a considerable bill.

Q. Well, what is your best estimate as to the figure, what do you figure, \$150 for each of the ten operations, wasn't it?

A. Yes. I mean I haven't figured anything, but I mean estimating it at \$150 that would be \$1500 there, and then——

Q. (Interrupting): How many visits did you make daily?

A. Daily visits.

Q. Daily for over a year?

A. Yes. I may have missed two or three days.

Q. And then were these dressings you made rather complicated? [75]

A. Some of them, yes, sometimes they take——

Q. (Interrupting) What is your best estimate now as to what the reasonable value of the services you have rendered is?

(Testimony of Dr. Raoul Esnard.)

A. I think with the accepted charge for hospital calls, which is, in Los Angeles at the moment is, \$5——

Q. (Interrupting) Well, would you say \$3,000 is a conservative estimate of the value of your services for the past year for the operations and——

A. Yes, I would say that that would be a fair——

Q. (Interrupting) Operations, dressings and all of that. By the way, I have a bill here from the California Lutheran Hospital. You were familiar with the treatment that Miss Canon received at the hospital? A. Yes.

Q. And she has been under your care at that hospital this entire time, hasn't she?

A. Yes.

Q. I will show you this bill, Doctor, and *as* you if you are generally familiar with the contents of it and know whether or not she received the bill?

A. Yes.

Q. It is a total bill for \$8,000—\$8,055.79, which includes various medical supplies and so forth. Does that represent what she received at that hospital?

A. Yes. Of course, I can't guarantee it to the penny, but [76] certainly they have kept an accurate record of all medications.

Q. Does this bill represent a reasonable value for all of the services she received there?



(Testimony of Dr. Raoul Esnard.)

A. Yes.

Mr. Wertheimer: I would like to offer this in evidence. Any objection?

Mr. Deasy: No objection.

The Clerk: Exhibit 6.

Mr. Wertheimer: May I say this, your Honor, the Doctor has suggested to me this: The reason Miss Canon is sitting with her foot in the box there is that he recommended, the doctor recommended, Dr. Esnard recommended she keep her leg elevated. Now, he suggested to me that the best way for the Court as the tryer of the fact to understand the full extent of the injury, that Miss Canon received, is to have an examination made of Miss Canon. He is prepared to cooperate in that. I found out now that he plans to leave for Los Angeles. Does your Honor feel——

The Court: (Interrupting) I don't think there is any necessity for that. The Doctor has described these—his services and the nature of the operations and the condition of the plaintiff and I see no point in subjecting the plaintiff or the Court to the examination of the plaintiff.

Mr. Wertheimer: It is as you will. [77]

The Court: If there were some dispute as to the nature of the operations that had been performed, or the present or past condition of the plaintiff physically, if that issue were raised under such circumstances it might be conceivable that the Court would need to see an examination, but I can't

(Testimony of Dr. Raoul Esnard.)

see that there is any necessity for that in this case. Well, do you want to let the Doctor go back to Los Angeles now?

Mr. Wertheimer: That is all at this time. I want to check over my notes and maybe we will go a little bit further, but I don't think so.

The Court: I think you have probably pretty fully covered the ground. I guess the Doctor wants to go back to Los Angeles.

Mr. Deasy: I have no further questions.

The Court: Well, he may be excused unless you want him to stay. We will recess until two o'clock.

After Recess—2:00 P.M.

Mr. Wertheimer: If the Court please, Dr. Esnard has returned. But before going to Los Angeles, before he went, he undertook to change Miss Canon's dressing. She is supposed to be back here any moment. I thought that in the interim I would read to the Court from the exhibit some of [78] the excerpts I thought most significant from the DeWitt Hospital record.

The Court: This is a part of the Plaintiff's Exhibit 3, isn't it?

Mr. Wertheimer: I think that was the number.

The Clerk: That is correct, your Honor.

The Court: And you are now, what you are reading is the only part of the exhibit that is to be in evidence, or are you reading parts of the parts that are to be in evidence?

Mr. Wertheimer: That is right, part of the parts that will be in evidence. It would be a rather lengthy proceeding to read it all, but I think I can argue from those parts which I don't read from but which are in evidence.

The Court: Well, you can read whatever you think is necessary to be heard or that the Court will need to know in listening to the evidence in the case or anything else. Of course you can argue from it if you wish.

Mr. Wertheimer: The first entry I will read is DeWitt Hospital, referring to Myrtle Canon, date of admission, 13th of June, '45. Age 32. Race W.

This is a record that is signed by T. B. Massell, Captain M.C., and reads as follows:

"Final diagnosis varicose veins, great saphonous system, severe on left, moderate on right.

"2. Anxiety, hysteria, severe, chronic; additional diagnosis: One ligation of saphonous vein, 14 June 1948, anesthesia local novocain. Two ulcer phagogenic, left thigh, due to infection with microaerophilic streptococcus and staphylococcus aureus, secondary to operation one above.

3. Operation, debridement of infected wound, 13 July, 7 September, 3 October and 29 October, 1945."

This is a transfer summary, of Myrtle Canon under progress notes and was signed by the same man T. B. Massell:

"Transfer summary: 24 November 1945.

"Patient was admitted 13 June 1945 because of

varicose veins of the left leg with aching and mild edema of three years duration. There were also asymptomatic varicosities on the right. There was a history of superficial phlebitis in 1943 on the left. Physical examination revealed extreme degree of obesity, permanent varicosities along the saphenous vein of both extremities, more marked on the left, incompetent perforators were demonstrated on the left just above the knee and in the mid-calf. There is a past history of hysterical laryngospasm, a few months prior to admission.

“On the 14th of June ligation of the saphenous vein was performed at the sapheno-femoral junction and in the lower thigh. A large perforator was located and ligated in the mid-calf at the same time.

“Post operatively patient developed cellulitis of the operative wound in the upper thigh which became locally [80] necrotic and broke down. On the 13th of July wound was explored, indurated fat excised and a closure of the fascia and vein was done, leaving a drain in place.

“Healing failed to occur, infectious process continued to spread despite various local applications and the use of penicillin.

“On the 27th of August a micro-aerophilic hemolytic streptococcus was found in association with staph aureus and diphtheroids zinc peroxide was started locally but response was not too satisfactory. On the 10th of September culture showed pseudomonas aeruginosa and an aerobic nonhemo-

litic strep. She was given a course of streptomycin, had numerous excisions of the wound edges starting on the 17th of October, 1945, and continuing to the 27th of October, 1945. She was given 800,000 units of intra-muscularly and 60,000 units intravenously.

“At the start of the treatment the infection was apparently controlled but then after a few days began to extend again. Streptomycin treatment was discontinued and zinc peroxide was resumed on a daily basis, doing dressings under anesthesia.

“Wound gradually became clean and at the time of discharge there were only two small areas at the upper lateral edge in which were unhealthy granulations.

“Because of the closing of DeWitt General Hospital, [81] patient was transferred to a civilian institution. Throughout her stay she was very unstable emotionally, was generally uncooperative and at times seemed psychotic.”

Here is a letter from Dr. Meleney to which reference was made numerous times, addressed to Major Norman E. Freeman under date of November 15, 1945 from Columbia University, College of Physicians and Surgeons, the Department of Surgery:

“Dear Norman:

I am sorry that my reply to your letter has been so long delayed.

You certainly have a very difficult problem on hand and have tried almost everything I can think of.”



I am reading from a part of this, Mr. Deasy, and if you wish to read more it is up to you. I will read the parts I consider significant.

“The fact the patient has pain inside the abdomen would make me think that the infection had already spread up through the veins and lymphatics beyond all reach of any local medication. If it is in the lymph glands of the groin it will be necessary to excise them, and if they are at all enlarged I would advise this. I would also advise excision of the overhanging, undermining skin margins.” [82]

Now, here is a record entitled Chief Complaint—Condition on Admission — Previous Personal History.

“Chief complaint, varicose veins. General appearance and condition on admission: well nourished, well developed individual who is cooperative and not acutely ill; occupation: medical secretary; propliteal service, none; habits, cigarettes—occasional, alcohol—occasional. Drugs, none.”

Then there is some previous personal history. Operations, Appendectomy, Tonsilectomy. None of which is significant—it tells about the condition of her parents. Another physical examination dated—well, it is D. K. 6—June 14, Myrtle Canon, civilian employee, Ward 117; height 5 foot 7 inches, normal weight 150, present weight 192 pounds, skin—then there is a blank for skin indicating no comment.

Head, including special senses, nose, mouth, throat and pharynx: Eyes—pupils round and equal and react actively to light and accommodation.

(B) Nose—symmetrical, there is no nasal obstruction and no septal deviation.

The Court: What is the good of reading that to me, that has nothing to do with the case.

Mr. Wertheimer: That is right.

The lungs—the lungs expand equally at both bases. [83] The breath sounds are clear and no rales are heard. There are no areas of dullness.

Abdomen: no tenderness or rigidity—muscle tone is good; muscular system, there is no atrophy or weakness. The muscle tone is good.

Service system: The reflexes are equal, active and physiological.

The Court: Does it say anything about her leg there in that examination or about the varicose vein?

Mr. Wertheimer: Yes.

“Vascular system: There are rather prominent varicosities along the saphonous vein both lower extremities. These are most marked on the left side where there are saccular dilatations two just above the knee, and one in the medial side of the mid leg.

“There is also a tortuous vein running along the anterior aspect of the left thigh. On the right side the most prominent varicosities are on the posterior aspect of the right calf, extending downward across the medial side of the popliteal space.”

That is the part she pointed to.

“The tourniquet test revealed the presence of perforators on the left just above the knee and in the midcalf. On the right I am unable to demon-

strate any perforators below the saphenous-femoral junction. [84]

“Heart tones clear, no murmurs are heard.”

The Court: There was something you read to me a while ago that said there was evidence of some phlebitis prior to that time. I was wondering whether that was part of this examination.

Mr. Wertheimer: No, I don't know what you are referring to.

The Court: You first read to me a document that had reference to that—it was a document that had to do with her admission to the hospital. I was wondering whether there was any comment on that subject in this examination you are reading from.

Mr. Wertheimer: “Chief complaint, condition on admission, previous personal history.” There is nothing in that, sir, about any phlebitis. On Chief Complaint it is varicose veins and there is nothing in that that indicates any phlebitis.

The Court: I was wondering if there was anything in this examination record of an examination by the doctor that you are now reading from that referred to that subject.

Mr. Wertheimer: The part I think you are referring to is “patient was admitted 13 June, varicose vein left leg with aching and mild adema three years duration.”

Mr. Deasy: The next sentence, Counsel.

Mr. Wertheimer: “There was also asymptomatic [85] varicosities on the right. There was a history of superficial phlebitis in 1943 on the left.

Patient first noticed——” This is part of the initial summary, working diagnosis, contemplated laboratory tests and consultations.

“Patient first noticed superficial varicosities on the calf of the right leg, posterior aspect, approximately three years ago. During the last year there has been an increase in the size of varicosities which have appeared on the anterior aspect, left thigh, popliteal space, left leg, and medial aspect of the left calf and the medial aspect of the right calf.

“There is also varicosities in the popliteal space in the right leg and thigh.

“Patient complains of mild swelling on the left ankle and aching of the left lower extremity. The right lower extremity is asymptomatic unless she is on her feet for a long period of time.

“Working diagnosis or impression: Varicose veins, both lower extremities.

“Contemplated laboratory tests and special examinations: CBC; Kahn; bleeding and clotting time; urinalysis.”

Now I come to the progress notes.

“Myrtle Canon.” The first entry is 14 June, 1945:

“Patient taken to surgery and ligation of the saphenous vein and in the sapheno-femoral junction, in the lower [86] thigh and in the midcalf, a large perforation being found in the latter portion and small perforators being found in the lower thigh.” Signed E. W. Rector, First Lieutenant.

“17 June, 1945: Patient has run a lowgrade fever since surgery and has had considerable pain and some tenderness in the left lower quadrant, the exact nature of which I am unable to determine.” Signed E. W. Rector, First Lieutenant M.C.

“20 June, 1945: Temperature is 101 today. Patient has been listless, wandering about and quite irritable. Examination of the wound reveals no evidence of any infection at present. The tenderness in the lower left quadrant has completely subsided. I am unable to account for her fever. White count has been ordered. Signed E. W. Rector, First Lieutenant M.C.

“23 June, 1945:”

The Court: That was six days after the operation?

Mr. Wertheimer: Yes, your Honor.

“23 June, 1945:”—this would be nine—“Temperature is subsiding. Wound has opened superficially and is draining a moderate amount of sanguino-serrous exudate. She is complaining of considerable pain in the entire lower left extremities are as follows:

“Thigh, six inches above knee, right 21 inches, left 20 and a half inches, calf six inches below knee, right [87] 14 and a half inches, left 14.

“I cannot see that the patient has any evidence of thrombosis of her deep veins and since there is no manipulation of the femoral vein, I see no rea-



son why she should have it but cannot account for her pain.

“25 June, 1945: Still complains of throbbing pain in the entire left lower extremity. Wound is not grossly infected but does not tend to heal properly.

“Measurements of the lower extremities are the same as of 23 June, 1945. She has been a febrile for the last four days. Signed E. W. Rector, First Lieutenant M.C.”

Then there is a skip in the record here to the 8th of July at 10:00 a.m. signed by Rector reading as follows:

“8 July——”

I have looked for the intervening records. I can't find them. I don't know where they are.

“Patient remains afebrile. Wound continues to remain open and drain huge amounts of blood stained serum in spite of what dressings, irrigations, and leaving it alone.

“Blood sugar taken yesterday revealed—reported normal cultures and CBC also taken. This morning on getting up after breakfast patient became very dizzy and fell to floor striking left frontal region. Examination at present reveals small swelling in left frontal region. Cranial nerves all normal, no bleeding from ears, peripheral reflexes [88] and motor functions all intact.

“Blood pressure 155 over 90—pulse 88. I do not believe patient received any intra-cranial damage——” Signed Rector.

"13 July—Patient taken to surgery, wound re-explored under pentathol and entire edges of indurated fat excised. No FB found."—whatever that means—"No abscess, no hematoma. Fat and fascia closed with catgut. Drain brought out through stab wound.

"Patient started on penicillin surgery."

That is signed Rector.

Here are some letters I am skipping over. Here is—I think I brought out that Miss Canon paid for some of the drugs and her board bill. Here is a letter from Major Freeman to Mrs. William Tarbutton, Box 12, Desert Hot Springs, California.

"Thank you for your letter——"

Mr. Deasy: Counsel, I thought that these letters were no part of the offer of the exhibit here.

Mr. Wertheimer: Well, to some extent that is true. Is there any dispute that Miss Canon—Miss Canon shall testify to the bill, took care of her board bill, paid some of her board bills and streptomycin and penicillin. She is not a free patient, in other words.

Mr. Deasy: I think she can testify to that herself. [89]

The Court: Yes.

Mr. Wertheimer: I won't read all of this. I will read the parts I consider significant.

Here is the streptomycin therapy case report. Let us see, in October they began the streptomycin treatment. This is a report dated 27 October, '45, De-Witt General Hospital, Auburn, California.

“Responsible Officer, M. E. Freeman, Vascular Surgery Section. Name of patient, Canon, Myrtle A. Diagnosis: Phagodenic ulcer of left groin. Symbiotic ulcer—undermining ulcer. Phagodenic ulcer of left groin. Date of onset, 17 June, 1945. Date of beginning of streptomycin therapy, 17 October, 1945.

“Bacteriology, (blank); blood, (blank); urine, (blank); wound, one, hemolytic strep (micro-aerophilic) two pseudomonas aerogenosa and three non-hemolytic strep (micro-aerophilic).” Then there is some material here on the sensitivity of the organism to streptomycin which I am unable to interpret.

“Complications due to drug, none; result at site of treatment, infection was apparently controlled for several days but then extension reoccurred.

“Sensitivity of organisms to streptomycine disappeared. Treatment failed. Norman E. Freeman.”

This is the temperature chart while she was being [90] streptomycin.

“Case summary: Patient is a 32-year-old obese single white medical stenographer employed in Vascular Surgical Section at this hospital. On 14 June, 1945, a left—” a word I can’t read—“saphenous vein ligation was performed in the operating room. Immediately after operation she ran a low-grade fever with excessive pain localized to the left lower quadrant and her wound.

“9 days post-operative the wound started to drain

large quantities of serro sanguinous material and eventually broke down completely.

“Fever was never marked but complaints of pain and tenderness were all out of proportion to the apparent seriousness of the condition. All types of local therapy unavailing. One month post-op exploration of wound was negative. Excision of skin edges with secondary suture—penicillin—unsuccessful. Culture staph aureus, blood chemistry normal. Try Vitamin C—Protein feeding—transfusions unavailing. By 7 September, '45, micro-aerophilic streps and staph aureus at last culture from wound so cautery excision and zinc peroxide occlusive dressing used. Spread continued despite zinc oxide—sulphonamides and penicillin with result:—” That must mean without result.

“The transfusions, ulceration clean and healing in center but spreading at upper edge. [91]

“17 October—streptomycin started with immediate improvement in comfort and rapidity of advancement. However, this continued for only 7 days when signs of recurrence were apparent. Although culture revealed disappearance of pseudomonas, the micro-aerophilic streptococcus was still present though”—a word I can't read—“on culture.

“27 October. Streptomycin treatment stopped.”

Now then this report continues:

“Possibly heavier dosage of streptomycin at the start combined with zinc peroxide occlusive dressing locally might have checked the infection.—”

Mr. Deasy: I move to strike that out, that last

part, your Honor. It appears under the title "Comments" and criticism and suggestions.

The Court: Who signed this?

Mr. Wertheimer: Well, this is part of the record under entire—entitled Case Summary. It is unsigned. Do you have one that is signed?

Mr. Deasy: It isn't signed.

Mr. Wertheimer: I think it is a comment on the record. I don't think it is proper so we will strike that.

The Court: Yes, I think that should go out. That is somebody's comment.

Mr. Deasy: It is speculative in the first place.

The Court: It is retrospectively made concerning [92] something that might have occurred if a different method were used.

Mr. Wertheimer: It is made by people under whose charge she apparently was, your Honor, and it is an entry that comes close to being a description of the fact. In other words, on effort within—

Mr. Deasy: I think it is pure speculation of a circumstance that possibly if something had happened, something might have happened.

The Court: Yes, that may be stricken.

Mr. Wertheimer: Here is a removal of some dressing and the progress notes—

"20 July, 1945: Patient has been complaining of pain about her wound, especially in the region where the drain was brought out. There is some induration in this region. There is steady profuse



serros drainage. Culture showed a staph-aureus which is sensitive to penicillin. Suggest daily irrigation of wound with penicillin solution, one to 500."

That was the 20th of July, 1945, and signed N. E. Freeman, Major.

"21 July, 1945: The drain has been removed. Wound has again opened and again has indurated"—a word, I can't make that out—something "surfaces. Wound being irrigated with penicillin as suggested above by Major Freeman. [93]

"Patient started on parenteral with about 300"—something—"daily. Her pain is at times all out of proportion to appearance of wound. I cannot believe that it is real." That is signed by Rector.

"27 July 1945: The wound is still draining profusely. Suggest insertion of sponge soaked with azochloramid 3 times daily with parenteral penicillin. Signed Norman E. Freeman, Major."

"3 August 1945: The wound is still draining profusely. I wonder if dietary restriction which has now put her weight down to 180 pounds may be associated with hypoproteinemia. Suggest serum determination. Norman E. Freeman, Major."

There is a record here of a dressing performed by Major Freeman on the 14th of October 1945 which I won't read the details of.

Then the progress notes skip back a little bit and here on the 18th of July and signed by Dr. Rector is:

"Patient remains afebril. Wound looks O.K.

Pain has been much less. Penicillin to be stopped. Rector."

I think it will appear later that the first penicillin that was given was on the 4th of July and the first sulpha drug on the 27th of August. The 21st of July:

"Wound is again separating and draining serum. Patient getting 300 mgs. of parenteral Vitamin C per day— [94] Signed Rector."

The 27th of July:

"Wound has broken down completely. Lower flap considerably indurated. To start hot compresses later Dakinization to be started. Patient has been getting penicillin past four days. Rector.

"10 August 1945. The serum protein determinations are at a normal level. The patient feels a great deal better although there is still copious drainage. Signed Freeman.

"15 August: Wound still wide open. The interior flap is under dissected as far as I can reach with gloved finger. Wound still exudes dark blood clots continually. Signed Rector.

"22 August: Status of wound still the same—wound edge biopsied and set for anaerobic culture. Sinear for amoeba negative. Wound packed with zinc peroxide. Patient still continues to be a tough nursing problem.

"24 August 1945: There is considerable sanguinous discharge from the wound. Suggest complete blood studies. Norman E. Freeman."

I will cut this as short as I can.

"Patient started on pencillin and sulfadiazine, Rector.

"23 August:" it says here, "Packing wound with zinc peroxide daily. Rector." [95]

"27 August: Patient shows marked anaemia. To have transfusion. Sulfadiazine used.

"29 August: Patient given 500 cc's of blood. Tissue culture reveals anaerobic staph. Wound is being packed daily with zinc peroxide. Rector."

The 31st of August, 1945: "Have now packed wound with zinc peroxide daily for a week. I believe it has shown some definite improvement though there is still considerable sloughing fat from the interior flap. There are two packets dissecting down the leg through the fat, one laterally, one medially. I am attempting to get the zinc peroxide packing down into these. Believe patient should be given another course of penicillin along with the zinc peroxide if no decided improvement within another week the wound should be laid wide open with the cautery and possibly excised."

Then there is another one I have difficulty reading, but it doesn't appear significant.

"August 31: Patient still continues to be temperamentally unstable. Today I gave her codeine grains"—so many—"nembutal solution one hour before the dressing which yesterday allowed her to sleep through the entire dressing. Today I could not arouse her to get her to turn over either verbally or by trying to turn her. However, when the nurse said something regarding the compresses for

her post"—something or other—"she awoke and started throwing [96] objects and making derogatory remarks at the nurse as though she had actually been awake through the whole procedure. I am sure there was no justification for her exhibition of temper. She flew into a rage which was almost uncontrollable. Signed Rector.

"7 September 1945: The fact that there has been continued breaking down of tissue, which involves even the skin flap is in harmony with the diagnosis of phagogenic ulceration associated with symbiotic infection of streptococcus and staphylococcus. Lt. Rector is going to open the wound up this afternoon and I believe that this saucerization should be performed. She should have at least three transfusions of blood today. Signed Norman Freeman.

"7 September: Patient taken to surgery and wound excised with cautery. Signed Rector.

"10 September: 300 cc's transfusion—Rector.

The 11th of September: "Wound being irrigated and dressed with zinc peroxide.

"22nd of September: Have been continuing to redress wound with zinc peroxide treatment. The wound has had a clean granulating base throughout. There is still considerable tenderness in the skin and subcutaneous tissue distal to the wound, however there is no cellulitis or induration present." He refers to three transfusions she had.

"2nd of October: Another area of necrosis has developed [97] in the interior flap and one on lateral

side of wound in last 48 hours. These areas will have to be excised. Rector.

“3 October: Interior flaps with tract and area of necrosis on lateral subcutaneous tissue excised with cautery. Wound cauterized and saucerized and dressed with zinc peroxide. Rector.

August the 31st—well, that refers to the patient’s temper and so forth.

September 6, 1945: “1200 cc transfusion. Wound being dressed daily and packed with zinc peroxide. However there are too many dissecting packets in the site and I believe it should be laid wide open and partially excised. Rector.

“September 7, 1945: Patient taken to surgery and all crypts of wound opened and then most of anterior flap consisting of fat and skin, the large—the former largely necrotic was excised. Signed Rector.

“17 October 1945: At dressing today the patient volunteered the information that she had had the most comfortable sleep since she had been ill. This is only 12 hours after starting the streptomycin. She climbed by herself from the guernsey to the operating table without protest.”

The Court: (Interrupting) Mr. Wertheimer, I don’t want to interrupt you but you are getting many months after the operation. Can’t you make just a brief statement as to what that is about, because that doesn’t enter into any [98] of your claim here, does it?

Mr. Wertheimer: To this extent in part, of



course, from the fact there is an injury and by this part her injury is severe and it also shows the treatment she got. There are significant entries to it, for instance, the lack of pus. Some of the characteristics of this ulcer is homogenic. Lack of induration of the arteries and all of those things I think will have some place finally in the argument of the case.

The Court: Well, you are 'way up now to October.

Mr. Wertheimer: Yes. I will skip this then. This (indicating) is from the treatment of the 13th of June:

“CBC, Kahn and bleeding and clotting time—” I don't want to repeat now on the treatment record, which incidentally skips around to September and October. I am turning over the pages of treatment to the latter dates, your Honor. Unfortunately they are not in order.

The Court: You are not really complaining about the later treatments. That is part of your case, I take it, as to the great suffering and pain?

Mr. Wertheimer: That is right.

The Court: And all the matters that go up and that are natural right up to the present time including what the doctor said on the stand this morning.

Mr. Wertheimer: I think once they made up their [99] minds to do something they did everything in their power.

The Court: I think that probably the United States Attorney would not protest against your

statement as to the severity of the—the duration of the pain and suffering endured by all of these operations that have taken place during the last year or two.

I think that you could submit that on the record itself. That phase of the matter. Would that be the case?

Mr. Deasy: I am anticipating that the lady will testify herself on those subjects.

Mr. Wertheimer: The record will corroborate her.

The Court: The record is there now and can be referred to. I am taking it for granted that Counsel has made a correct statement of the many operations and the pain and suffering and all of the difficulties, the present difficulties that the lady has. I think that will be borne out by the testimony of the doctor that has already testified. I don't think you need to dilate upon that because the record you have there, plus the testimony of the doctors—the doctor that has testified of course and what the lady may have to say herself would be——

Mr. Wertheimer: I think that is true. I have to, however go through the record to bring out——

The Court: (Interrupting) Of course the crux of the matter is whether or not there was any malpractice at the [100] time of the operation or immediately subsequent.

Mr. Wertheimer: That is correct.

The Court: That is the only issue in the case, because whatever happened afterwards is something

that happened and continued on and resulted in all of these various operations.

Mr. Wertheimer: Yes.

The Court: And no matter how aggravated in need or how horrible that situation may have been is itself not of any importance in determining the question of whether or not there was a cause of action based on that.

Mr. Wertheimer: That is true.

The Court: That goes to the element of damage.

Mr. Wertheimer: Exactly. There are things in the latter record though that I have called to your Honor's attention now to indicate such things as this: That there was no infection at the time of the operation and when the first—I have called your Honor's attention to the first entry in the record concerning the administration of penicillin and concerning the administration of one of the sulpha drugs and items like that. That is the reason I am trying to go through this as fast as possible.

Now, another thing there is nowhere in this record whatsoever, and I think it is significant, and I suppose the only way I could prove it would be by reading the whole thing, but I will make the statement and if Mr. Deasy wants [101] to have the complete then—nowhere in the entire hospital record of any of the people observing her and treating her was there any statement that she was causing this infection herself.

Now, here is a radiologists record taken on June 1945 with respect to the varicose veins which I

think indicates there was no phlebitis before. They have all pointed to that. I don't think there was and I think the record is clear on that but I might explore it.

A phlebogram of the left lower extremity by injection of a superficial vessel at the ankle, visualizes what is thought to be an adequate deep veinous circulation about the lower leg and calf region, however, the outline is lost at the proximal end of the tibia. On the firm of the upper leg the popliteal vessel and the femoral are outlined well and would substantiate adequate deep veinous circulation in the calf region. Again visualized is a tremendously dilated long saphenous system with large tortuous vessels in the thigh region. Though faint, it is believed that the outlines are sufficient for adequate deep veinous drainage in event of tying off varicosities about the calf and thigh regions. It is signed Rector. There is, on number 84 is a clotting time. I can't read them, but the clotting time is five minutes 45 seconds and the bleeding time is two minutes. The red blood count is 3,710,000, and the white blood count is 5,900, [102] just before the operation, which indicates that there was no evidence of any infection on that point and the urinalysis taken on June 13th, 1945 shows the same.

Here is the operation report of the first operation by Rector which I read to your Honor.

The Court: I beg your pardon?

Mr. Wertheimer: This is the operation report of the operation for the vein or veins on the 14th

of June, 1945. It is in the record. Do you want me to read it at this point? I don't think it has any significance.

The Court: That is up to you to decide. I can't tell.

Mr. Wertheimer: All right. Post operative diagnosis: "Bilateral varicose veins."

The Court: Read it if you think it is of any importance.

Mr. Wertheimer: All right. "Post operative diagnosis: Bilateral varicose veins. There is no indication of any phlebitis at that time after the operation. Operation left high saphenous and low saphenous ligations.

"Remarks: After infiltrating the left groin with novocain the sapheno-femoral junction was exposed through a transverse incision paralleling and just below poupart's ligament. Several tributaries of the saphenous vein at the sapheno-femoral junction were then divided between clamps and ligated after which the saphenous vein was divided between [103] clamps and doubly ligated on both ends. No sclerosing solution was injected into the vein. Upon further exploring the femoral vein at the sapheno-femoral junction, a large tributary on the medial side of the femoral was found, possibly the deep medial femoral circumflex, and this was also divided and ligated. The wound was then closed with interrupted cotton sutures, and a second incision made on the saphenous vein just above the knee. Here two small perforators were found and both these



divided and ligated, as well as ligating the main saphenous vein. A large dilated varicosity was found in this area.

“A third incision was then made at about the junction of the middle and lower one-third of the leg over the saphenous vein, and at this point a very large perforator could be seen entering it from the deep fascia. First the saphenous vein and the perforator were ligated between clamps. Pressure dressings were applied and the patient returned to ward.”

Then follows some operation reports, one dated the 15th of July—“Postoperative diagnosis: Granulating wound with that necrosis. Operation: excision of wound.” The operator was Dr. N. E. Freeman, assistant Dr. Rector and the description of what was done was then given.

On the 7th of September 1945 an operation report, “Postoperative diagnosis: Anaerobic staph injection of [104] previous wound for ligation of external saphenous vein on left thigh. Operation: excision of wound.”

This is September 7th. “Remarks: After the area was prepared, the various recesses and undissected pockets of the wound were explored and laid open with a bovie unit. These were found to extend down the anterior surface of the leg for about three inches and down the anterior medial surface for about three inches and up onto the mounds. The lining of the pockets of these recesses were found to consist of indurate thick

yellow looking necrotic, subcutaneous fat, which apparently harbored the infection. The base of the wound did not look so bad and yet had considerable amount of indurated necrotic fat."

Another operation on the 3rd of October. "Post-operative diagnosis: Phagogenic ulcer, secondary to wound of left side for ligation of saphenous vein. A previous excision had failed to control the infection. This left the wound entirely saucerized without any overhanging flaps.

The 29th of October, 1945, a dressing with zinc peroxide. Temperature treatment beginning the 13th of June. On the 14th of June they show a temperature of 99 in the morning and 99.4 in the afternoon. Under medication and nurse's notes the main entries are codeine and sodium luminal and the like.

On the 15th of June the temperature in the morning [105] was 99 and 99.4 in the afternoon, and later 99.8. Sodium luminal given and codeine. Patient's temperature on the 16th of June was 100.06 in the morning and 99.4 in the evening.

99.4 throughout; there are complaints on the 16th of June, complaints of some left groin pain and nausea. Earlier dressing and codeine for pain.

Now on the 17th of June in the a.m. the temperature was 100.4 and later in the day 101.2. It shows that the dressing is changed and Ace bandage re-applied.

The Court: What was the day of operation?  
The 14th?

Mr. Wertheimer: Yes, your Honor.

On the 18th of June temperature 100.8. On the 19th of June no temperature. The reading is still complaining.

On the 20th of June the p.m. temperature is 101. None of these entries—I won't read all they have as to medication and nurse's notes until I come to something significant.

As far as the number of the drugs that were given, they were spoken of this morning. The 20th of June, a 98.6 temperature.

Routine care, some bleeding. Patient crying, codeine for pain.

The 22nd of June, routine care. Temperature on the 23rd 98. On the 27th of June routine care. Moderately large amount of bloody drainage. Temperature throughout this period normal.

The 29th of June, bleeding profuse tonight. Codeine [106] and then we come to July.

Complaining of pain, frequently hysterical.

Here is the first entry with respect to any of the antibiotics. The 4th of July, temperature 97.4. Routine care. In the morning condition seems better—mental condition seems better. Dressings changed. Penicillin pack in wound, states lower leg feels very good. That is the 4th of July.

The 8th of July, dressing changed. Large amount of drainage of blood stained serros. Temperature 98.6. Dressings and penicillin were given around the 9th, the 10th and the 14th of July. I am not reading them all to save time.

The 24th of July, penicillin. Routine care, copious amount of four smelling drainage. I skipped a lot of this.

On the 7th of August, crying; the 8th of August, routine care; 8th of August, dressing changed, bloody, luminal.

Going through these in September very rapidly to save time, September and August. Here is an entry on the 26th of August, your Honor. The first I have been able to find.

No. 144, Mr. Deasy.

Sulphadiazine. It describes the dosage which I am unable to read. That is the 26th of August, sulphadiazine. There are others, but I won't read them in the files.

There are several pre-operative examinations and anesthesia records that were made at the time by Dr. Rector, and changing her bandages and cutting away the edges of the [107] wound sometime in November and in October.

There are numerous pre-operative examinations and anesthetic records. I haven't counted the number of them. They deal with the change of dressings and under anesthetic.

The Court: Counsel, I don't wish to appear to be complaining, but this is a part of the preparation work of attorneys. This has been going on now for an hour while you examine these documents and pick out these things. Now, that is work that should be done before the trial of the case. I have lots of cases waiting for trial here, and I don't wish to be

critical, but this takes up too much time for you to do your studying now. You are examining these documents. They were here and you could have examined them and picked out what you wanted before.

Mr. Wertheimer: Well, they have been examined by me, your Honor, a dozen times prior to trial, but they are in the custody of the Court, and I have to go through these again and again and pick out what I consider significant. I picked out those that I recognize from having gone through before and having something of significance. I am not culling these for the first time.

Here is the pathological report of the pathological examination of the tissue dated July 13, 1945. That was the date, you remember, of the first operation that followed the one on the 14th of June. Dated July 14. [108]

“Gross: Received a large regular mass of predominantly fatty tissue”—of a certain size—“which on section is a tubular structure having a small central lumen completely occluded by dark grayish—brown material. The large mass, on section, shows a considerable amount of fat with fibrous tissue around the periphery and contains numerous grayish brown degenerated mottled areas.

“Microscopic: Section through the fatty mass shows a good deal of necrosis of fat and soft tissue as well as an acute and chronic inflammatory reaction with some fatty fibrosis. Involved in this mass is a small lymphnode which also shows evi-



dence of chronic inflammatory changes, resulting in some fibrosis of the strona, distortion of the follicular structure and some reticulo — endothelial hyperplasia. Section through the blood vessel shows what is probably a thickened slightly fibrotic wall of the vein which is completely occluded by a well organized thrombos. The initial layer of the blood vessel is quite thickened and has a hyaline appearance. Diagnosis: 1. Phlebo-sclerosis and thrombosis, 2. cellulitis, acute and chronic with necrosis and, 3. fat necrosis.”

“That is a July report.

The debridement, the operation on the 17th of August, 1945, shows a diagnosis of——

The Court: Why don't you put your client on the [109] stand. She left her seat in here in the court room. She is obviously getting tired while you read all of this. This could be handled in some other way it seems to me.

Mr. Wertheimer: Well, the records in this case are relatively lengthy. I don't propose to do the same with the records of the DeWitt Hospital. I don't know how else to get them before your Honor. It is either a question of your Honor reading those parts that are significant, or my calling them to your Honor's attention.

The Court: I can't see where all of these records of the various operations that took place afterwards have got anything to do with the claim of malpractice.

Mr. Wertheimer: Well, your Honor, I certainly

had to read the temperature chart and I have to show your Honor that the first culture that was taken was taken on the 6th of 7th of July.

Now, you asked me what was the significance of the tissue examination. It is most significant that the tissue—that the pathological examination of tissue made on the 13th of July shows a chronic inflammatory condition of considerable—that existed a considerable length of time, and that even Dr. Rector admits, the infection started shortly after surgery.

Now, I can't argue my case, your Honor, as I go along very well, but on the other hand I can't dump these in [110] your Honor's lap. I have culled these records a dozen times and I know what is significant and I must read those things so that when I later in argument refer to them the significance will appear. I have only myself to criticize if the thing is onerous and tedious, but I have no other way of doing it.

I am not going to read them, but here are blood transfusion records showing, as I recall, during the time she was there apparently 20 transfusions. I will satisfy myself with that statement.

Now, here is, your Honor, one reason that I am forced to read these laboratory reports and that is this:

Upon examination and investigation into the case, some of the doctors claimed that there was no such bug and she never in fact had it. It may seem strange to your Honor, but I think there may be

testimony in this case that some of the doctors were unable to isolate it. That is the reason they charge her with self-injury.

Now, the only way I know to prove that, your Honor——

The Court: (Interrupting) But there isn't any evidence of any self-injury in the case. You are just anticipating something. The United States Attorney made a statement that there might be, but that there will be any evidence on that—maybe there will be—but you needn't anticipate it until it is—there is evidence on that score. [112] That is unnecessary.

Mr. Wertheimer: Maybe——

The Court: (Interrupting) Isn't that right, Counsel? You are anticipating.

Mr. Wertheimer: I suppose that is true, your Honor. It might appear I am a little bit, and it might save time in the long run. Here is the laboratory report of October 19, 1945 showing a hemolytic strep, micro-aerophilic pseudomonas non-hemolytic strep, but it is a laboratory report of the DeWitt Hospital.

And then there is a laboratory report on the 27th showing the same. There are other laboratory reports but in accordance with your Honor——

Now, here is the first culture, your Honor, that appears to have been taken by process, judging by the fact that there are no other cultures from the date of the operation until this one of the wound. It is dated July 14, 1945.

There is an earlier one; it is dated July 7, 1945. That was the first culture that was taken of the specimen which was the drainage from the wound and it reports no organism seen, that means it is visible to the naked eye.

I think that is all I have at the present time. Do you want to proceed or take a short recess?

The Court: We will take a recess and then proceed with your client. [113]

(Short recess.)

(After recess.)

Mr. Wertheimer: Miss Canon, will you take the stand?

Thereafter,

### MYRTLE CANON

previously sworn, testified as follows:

#### Direct Examination

(Continued)

By Mr. Wertheimer:

Q. Miss Canon, while you were in the hospital at DeWitt, did you pay any of your bills?

A. Yes. Civilians when they go in has——

The Court: No, just answer the question yes or no.

A. Yes, I did.

Q. (By Mr. Wertheimer): Did you pay—I will show you here some receipts, what are those for, penicillin?

A. Those are receipts for penicillin I paid.

(Testimony of Myrtle Canon.)

Q. Did you pay for all the penicillin?

A. No, I paid for it for a while until I ran out of money and then they paid for it.

Q. Do you have any recollection of the total amount you paid for penicillin?

A. No, I didn't.

Q. Did you pay for your subsistence while you were in the hospital? [114]

A. Yes.

Q. Do you have any recollection of how much?

A. I don't know what the total was. I paid \$1 a day.

Q. \$1 a day subsistence for every day you were there?

A. Every day you were a patient.

Q. Your best recollection is you paid that?

A. Yes, I paid it.

Mr. Wertheimer: I would like to offer all of these.

Q. Are these all receipts, all of the receipts you have for the penicillin?

A. I think so.

Mr. Wertheimer: I would like, if the Court please, to offer as plaintiff's exhibit next in order these receipts for the penicillin payments.

The Clerk: No. 7.

Mr. Wertheimer: And then I have——

Q. Will you tell me what that is? Is that a receipt for your subsistence?

A. That is a receipt for subsistence.

Q. Do you have any more receipts?

A. I think I have some more, some more at home.



(Testimony of Myrtle Canon.)

Q. Some more at home, you didn't bring them with you?      A. Not today.

Q. You mean you have them in the hotel?

A. They are in the hotel. I believe I do. I wouldn't swear [115] I do, but it seems to me——

Mr. Wertheimer: Would you stipulate she paid her subsistence bill while she was in the hospital?

Mr. Deasy: Well, I will object to the offer of those bills on the ground they are incompetent, irrelevant and immaterial unless you can establish that she wasn't paying subsistence before this operation while living there at the hospital. I don't see how they would flow from the operation that she paid for her meals.

Q. (By Mr. Wertheimer): Were you paying for your subsistence before you went into the hospital?      A. Yes, because I lived on the Post.

Q. I see. Then you continued to pay, is that right?      A. That is right.

Q. At the same rate?

A. Well, they put you on a different—I think you are a different status when you are a patient. I don't remember, but I think it is more.

Mr. Wertheimer: Well, I will offer, if the Court please, this receipt. I may have occasion to offer others later showing Miss Canon while she was in the hospital paid this on account of her subsistence.

Mr. Deasy: I object to it on the grounds stated. I can't see its materiality.

The Court: I don't see the materiality of it. The

(Testimony of Myrtle Canon.)

plaintiff was a civilian employee of the Army. She paid a certain amount per day for subsistence while she was living there on the post, and she said she continued to pay that while she was in the hospital.

Mr. Wertheimer: All right.

The Court: I can't see that it has any bearing on the case.

Q. (By Mr. Wertheimer): Do you recall whether there were any other drugs you paid for, Miss Canon?

A. I was asked to pay \$200 for streptomycin. I didn't have the \$200. They wired my family, my mother sent a money order for \$35 to Major Freeman and she said they would send more later. When I was discharged from the hospital Major Freeman gave that \$35 back to me so apparently they never used it. They asked me to sign——

Q. (Interrupting) Well, that is——what were you going to say?

A. I was going to say they asked me to sign a statement saying that I didn't have the \$200 to pay for the streptomycin which I did.

Q. Now, what—did you receive any treatment in the hospital in addition to those of which there is some evidence in the record, that is, zinc peroxide, zinc peroxide dressing and streptomycin, before the debridement operations?

A. Before the surgery, you mean? [117]

Q. No, I mean did you receive any treatment at all while you were there in addition—after the

(Testimony of Myrtle Canon.)

surgery of June 14?           A. After surgery?

Q. Yes.

A. Not for the—not for the first. Well, as I recall it wasn't until around the 13th of July that, after that second operation that they began giving me penicillin and stuff.

Q. Yes. Well, what I was getting at was this: Did you have your dressings changed in surgery while you were there?

A. Oh, in surgery, yes. Four weeks I had them done under an anesthesia every day in surgery.

Q. Do you know how long a period that was for?

A. Oh, I would say four weeks, offhand.

Q. And who did that, Dr. Rector or Major Freeman?

A. Major Freeman did it because Dr. Rector was a patient in the hospital for a while and this Captain Maselle did it later.

Q. Now, when did you leave the DeWitt Hospital?

A. As I recall it, October 29, 1945—no, November, pardon me, 29, 1945.

Q. And where you removed to?

A. I was removed to the University of California Hospital here in San Francisco.

Q. How did you get from Auburn down to San Francisco?

A. I was taken by Army ambulance to Sacramento and then [118] brought from Sacramento

(Testimony of Myrtle Canon.)

in a Red Cross ambulance. Army nurses accompanied me to Sacramento.

Q. You were—then you went out to the University of California Hospital on Parnassus and Second Avenue? A. That is right.

Q. Was your wound dressed at that time? What dressing did you have on?

A. When I left DeWitt?

Q. Yes.

The Court: What is the pertinency of this?

Mr. Wertheimer: Well, I have got to show the treatment at the University of California, and I want to show the condition she was in when she got there, your Honor. She came there by ambulance. The wound was still dressed and she was still suffering from the same ailment. I am going to try to be as brief as I can about the treatment at the University of California Hospital, but I assume—

The Court: I could understand that if there was such an issue here, of how the wound was dressed at the time she got to the University of California. What is the importance of that? You bring in so many details that it is hard for me. You dig into it and throw all of this material out of a basket and get in the issues of the case those matters that don't seem to me to have any importance. Even how she was transported, what has that got to do with it? [119]

Mr. Wertheimer: We will make it as—telescope it as much as I can, your Honor, and still cover

(Testimony of Myrtle Canon.)

the treatment. There is four years' treatment I have got to cover here.

The Court: I will grant that you can get in the trial that she got to the University of California and then take her on from there and find out what happened to her there.

Q. (By Mr. Wertheimer): You arrived at the University of California Hospital. Now, can you tell us what the treatment was that you received there as well as you can recall?

A. I arrived there on a Saturday. Monday I had a skin graft and then, approximately—oh, I forget, but as well as I can remember it was about two or three weeks later the infection apparently became very active again.

Q. Where was the skin graft you said you had done?

A. On the wound on the thigh that had been excised in the Army. That had granulated up and they skin grafted it.

Q. I see. And then you were in bed, not ambulatory, were you?      A. That is right.

Q. And then what is the next treatment you received?

A. The next treatment was, I would say, approximately six weeks later when Major Freeman came down. He recognized the infection was acting up again and I was taken to surgery that night for an apparent excision or opening of just the sinus tract, but when they got in there the whole



(Testimony of Myrtle Canon.)

left side [120] was involved and they did a radical saucerization of the left side.

Q. Now, the left side, what do you mean, the leg?

A. Left abdomen; no, no, not the leg, the abdomen. It had extended up underneath into the abdomen.

Q. Into the abdomen?

A. That is right.

Q. And that was the area that was excised this first operation?

A. That is right.

Q. What treatment did you receive in the intervening six weeks' period, just bed rest, is that all? You stayed in bed?

A. I stayed in bed and they irrigated the graft area with a penicillin solution.

Q. Any other treatment?

A. Oh, as I remember just routine.

Q. Routine care. Now, following the operation on the left, up to the left side, did you have any—what treatment did you receive following that?

A. They went back to zinc peroxide dressings at the request of Major Freeman and blood transfusions.

Q. You were receiving blood transfusions?

A. And following that it kept persisting and I just had numerous excisions just one right after the other.

Q. What area did those incisions cover? [121]

A. Well, in time it involved the whole abdomi-

(Testimony of Myrtle Canon.)

nal wall back into my back on the left side and went down the left thigh again in one area—in two areas it just kept breaking out and breaking out and breaking out.

Q. And were the excisions bigger there?

A. Yes, that is right. They had excisions and finally they had to excise part of the pelvic bone.

Q. Part of the pelvic bone?

A. Part of the pelvic bone.

Q. You mean the infection extended back to your left pelvis, is that right?

A. It was way back into the back and up into here (indicating). They had to take part of the bone. I had numerous skin grafts. I can't tell you the exact number because I was too sick and I was going to surgery too often.

Q. Do you have any knowledge of, while you were at the University of California Hospital, how many operations you had?

A. I wouldn't want to give you a statement because I can't tell you exactly.

Q. Not exactly?

A. There were too many. As I said, I was going to surgery very often.

Q. Well, the records are here. What other treatment did you receive at the University of California?

A. Oh, I had lots of penicillin and I had streptomycin and [122] I had furicin, which is a topical application of the drug.

(Testimony of Myrtle Canon.)

The Court: The records of the University of California Hospital are here, aren't they?

Mr. Wertheimer: Yes, your Honor, but even I quell at that. I saw them for the first time yesterday when they were brought into Court, and they are twice as thick as the government record. I am trying to get as much as I can from her.

The Court: Well, they probably—the examination will show all of these things.

Mr. Wertheimer: I don't think there will be any question about it.

The Court: I think that you are all right here without having to go through all that medical history that the University of California Hospital—it must be all in these records.

Mr. Wertheimer: The alternative I have is this, your Honor. I haven't seen the records. I can go through them and then summarize them or I can while she is on the stand give as pithy a summary as I can on the treatment there.

The Court: Wouldn't it be fair if I were to ask the witness a general question that might cover it?

During the time you were in the University of California Hospital, you had a large number of operations one after the other in which this abscess was being pursued by the [123] doctors to where it developed it was excised. That you had skin grafts and you had blood transfusions and you were almost constantly in bed during that period of time?

(Testimony of Myrtle Canon.)

A. Yes, I was.

The Court: Would that be a correct statement?

A. Yes, that is right. As you say, I just had numerous operations and skin grafts and blood transfusions. I couldn't tell you the number because there were too many, but I do know that they gave me all kinds of streptomycin.

The Court: And during all of this time you were bedridden most of the time?

A. I was only up about—about two weeks up and down at U.C. I was in bed practically the whole time.

The Court: And during that time you had great pain and discomfort all of the time and you were under opiates, were you?

A. Yes, most of the time. I had a special nurse for quite some time over there.

Mr. Wertheimer: Now, when did you leave the University of California Hospital?

A. I think it was October 5, 1940—Let's see, where am I?—6?

Q. 1946 in October. And where did you go then? A. San Francisco County.

Q. San Francisco County. Didn't they first—you had been [124] hysterical on many occasions, hadn't you, at the University of California Hospital? A. Yes.

Q. And been a difficult person?

A. That is right.

Q. And didn't they first move you to Ward—

(Testimony of Myrtle Canon.)

the Psychopathic Ward at the—withdraw that. I mean at San Francisco, the City and County Hospital?      A. Yes, they did.

Q. And then you were examined by doctors there who immediately said what you needed was treatment for your infection, isn't that right?

A. That is right.

Q. And you were taken from there to the General Wards of the Hospital and given treatment?

A. That is right, and emergency surgery there.

Q. And you had emergency there. Now, did you have numerous operations while you were at the San Francisco Hospitals?

A. Yes, I did.

Q. Do you recall that?

A. Yes, and a lot of blood transfusions.

Q. Lots of blood transfusions.

The Court: How long was the plaintiff in the San Francisco Hospital? [125]

Mr. Wertheimer: About a year.

The Witness: About a year.

Q. (By Mr. Wertheimer): Now, while you were in the San Francisco Hospital they put you in Ward 42 on more than one occasion, didn't they?      A. Yes.

Q. When you became particularly obstreperous?

A. Yes.

Q. And sometimes you threw things at the nurses, didn't you?      A. Yes.

Q. Now, let me ask you this: Did they, while



(Testimony of Myrtle Canon.)

you were at the San Francisco Hospital, put you in a cast?

A. They certainly did. They put me in three of them.

Q. All right now, and tell us—the first cast—what was the first cast they put you in, when was it, do you remember? If you can, approximately.

A. I think it was about early June.

Q. Early June?

A. And I would say from my armpits below my knees.

Q. From your armpits to below your knees. How long did you stay in that cast?

A. I would say about six weeks.

Q. And then was that cast removed?

A. That cast was removed because I complained of pain so much underneath and I lost so much weight that they took [126] me out of it. The whole body was burned from the drainage of the exudate from the wound. I had lost about 30 pounds while I was in the thing. The same day they put me in the second cast.

Q. You mean right after six weeks in that cast they put you in another cast?

A. The same day, the same day they put me in another cast from my neck. Pulled my legs apart as far as they could, put a binding between my knees, and I was left in that cast for six weeks—no three and a half months in that cast. I complained of pain in my abdomen and back and

(Testimony of Myrtle Canon.)

under my arms and I was generally just absolutely miserable. It was during that period that I was thrown in "Psyc," and as I say when they took—finally I did get very sick and I apparently very anaemic. They took me out of that cast and when they took me out my whole leg was burned from the exudate and my body was—my cast was full of live maggots.

Q. How do you know that, did you see them?

A. I saw them.

Q. Were you receiving things for your pain, opiates during this time?

A. No. When I was in the cast they told me the pain was in my head. For a while they gave me red sleeping tablets but finally they wouldn't even give me an aspirin tablet.

Q. I see. Now, after the second cast was removed, were [127] you put in the third cast?

A. It seems to me I was taken from the cast that was filled with the maggots and I was put in a similar cast of the same type above my elbows, from my neck to above my elbows to below my knees with my legs separated.

Q. And how long were you in that cast

A. I was in that cast about seven weeks that I recall, and then transferred to Los Angeles County.

Q. Then the total amount of time you were in a cast was—let's see, the first was how long? Three months, is that what you said?

(Testimony of Myrtle Canon.)

A. Six weeks.

The Court: Are you going to go all over that? It is already in the record.

Q. (By Mr. Wertheimer): You were put in these casts and you were told you were put in these casts because you were told it was suspected you were tampering with your wound and opening the wound yourself, is that right?

A. That is right.

Q. Now, while you were in these casts, was it possible to do—first of all, let me ask you this question: While you were at the University of California Hospital, did you attempt to go under your bandage and tamper with the wound?

A. I certainly did not.

Q. Now, while you were at the University, the San Francisco [128] City and County of San Francisco Hospital, and before you were in the cast, did you attempt to get into your wound?

A. No. I certainly did not. As a matter of fact, I had experienced nurses all of the time, three shifts and my hands were kept in restraint and besides, the only time they took one hand out was when the nurse was in the room. The infection spread very rapidly in spite of that.

Q. Now, was it possible while you were in the casts for you to open the wound?

A. No, it was clear up to my neck.

Q. Did you attempt to do so? A. No.

Q. Now, did you have more operations of the

(Testimony of Myrtle Canon.)

same kind at the San Francisco City and County Hospital?

A. Before I was put in the casts I did. They did the same kind of operation that they had at U.C.

Q. And then after that they left it alone?

A. After that they left it alone.

Q. And figured it would heal by itself?

A. Yes.

Q. Let me ask you this, Miss Canon: Mr. Deasy has seen this. This is the bill which you received from the City and County of San Francisco?

A. That is right.

Mr. Wertheimer: I would like to offer this bill if [129] the Court please, from the City of San Francisco to Miss Canon for the period October 5, 1946, to October 28, 1947, in the total sum of \$4,660, which includes 388 days at 9 plus a day and specialty nurse, 540, and blood transfusions 500. Do you have any objection?

Mr. Deasy: No.

Mr. Wertheimer: Will you stipulate that that represents the reasonable value of the services, Mr. Deasy?

Mr. Deasy: Well, I think it does, yes.

Mr. Wertheimer: All right, thank you.

The Clerk: That is exhibit 8.

Q. (By Mr. Wertheimer): And then you were moved down to Los Angeles about what time?

A. That was October 28, 1947.

(Testimony of Myrtle Canon.)

Q. And were you moved—were you in a cast at that time?

A. I was still in the cast. I was moved in the cast.

Q. I take it you got down there and you went—you were in a cast and taken to the train in an ambulance and so forth? A. That is right.

Q. And to the hospital. Now, you went to the County Hospital down at Los Angeles, is that correct, first? A. That is correct.

Q. And how long were you there?

A. I was there——

Q. (Interrupting): 'Til the first of—— [130]

A. (Interrupting): Until the early part of January.

Q. January 12, 1948, is that right? From October—— A. That is right.

Q. ——29,—— A. That is right.

Q. ——a total of 75 days you were in the skin ward, is that right? A. That is right.

Q. Now, did they remove the cast down at Los Angeles?

A. They removed it immediately as soon as I got there.

Q. And what was the condition of your body at that time?

A. My whole abdomen was ulcerated from drainage. This leg, it was ulcerated on top. Apparently this one place down here had healed but the abdomen wasn't healed.



(Testimony of Myrtle Canon.)

Q. The abdomen wasn't healed. What evidence was there it was ulcerated?

A. Superficial ulcer. There were sores all over me from drainage.

Q. Sores from drainage? A. Yes.

Q. Anything else that you can——

A. (Interrupting): No, only this area over my abdomen was very, very tender. I didn't look real close at it but——

Q. (Interrupting): You had a lot of skin grafts?

A. There was a lot of scar tissue.

Q. Now, did you have any surgery at Los Angeles? [131]

A. I had practically no treatment at Los Angeles County. I didn't have—I didn't even have a blood count down there.

Q. Did you have any transfusions?

A. I had no transfusions whatever.

Q. What treatment did they give you down there?

A. I did most of my own treatment. As a matter of fact, they just give you local ointments to put on. Only I did get more—on my leg they did give me heparin and bicumeral, anti-coagulates.

Q. And did you have to do your own dressings?

A. I did my own dressings. I just put—you put your own compresses on and do your own dressing. The dressing nurses pass out the dressing and the ward doctor sees you occasionally. You are seen

(Testimony of Myrtle Canon.)

by the Chief of Staff about once a week down there, but actually your daily dressing, most patients do their own on that ward. I don't know anything about the rest of them.

Q. This is the bill you received from the Los Angeles County Hospital, 75 days at 5.46, a total of \$409.50? A. Yes.

Q. That is 5.46 a day. I will offer this as our next exhibit in evidence. There is no question but what that represents the reasonable value.

Mr. Deasy: It seems to be more reasonable than the San Francisco Hospital. [132]

Mr. Wertheimer: They did a lot less for her——

The Witness: That is for sure.

Mr. Wertheimer: Or to her.

The Court: How much is that?

The Clerk: 409.50. That is Exhibit 9.

Q. (By Mr. Wertheimer): Now, before—then you left the Los Angeles Hospital?

A. They discharged me.

Q. They discharged you, and how long did you—when did you enter the California Lutheran Hospital?

A. The 31st of January, 1948; I went to Dr. Esnard on the 29th.

Q. And the date of your discharge at the Los Angeles Hospital was—do you remember when it was?

A. The date of my discharge from where?

Q. Los Angeles, was the 12th of January?

(Testimony of Myrtle Canon.)

A. The 12th of January I went to my aunt.

Q. So within a week you went to Dr. Esnard?

A. It was within a week. I apparently had a cloth on my leg when I was discharged.

Q. You went to him. Were you still ulcerous at that time?      A. That is right.

Q. Now, at the California Lutheran Hospital, what—can you tell briefly what treatments you received?

The Court: Didn't Dr. Esnard pretty well cover that?

Mr. Wertheimer: I beg your pardon; he did, your Honor. [133]

Mr. Deasy: I think he covered it, your Honor.

Mr. Wertheimer: I think he pretty well did.

The Court: I don't think you need bother the plaintiff with that. He told us just what he did, isn't that right?

The Witness: That is right.

Mr. Wertheimer: I think that is all now, your Honor.

The Court: Have you any more witnesses, Mr. Wertheimer?

Mr. Wertheimer: No.

The Court: I am just trying to find out, as far as—you will have some cross-examination, will you?

Mr. Deasy: Yes, your Honor. If that could wait until the morning I would appreciate it.

The Court: Have you attempted to produce any witnesses tomorrow?

Mr. Deasy: As I explained to the Court, I am unable to get my witnesses here for tomorrow in view of the fact that there is a convention of some sort here, or a convention of surgeons which they are all attending.

The Court: Who are you going to produce as witnesses? In order to get a continuance, you will have to make some statement to me as to whom your witnesses are and what they are going to testify to.

Mr. Deasy: Yes, your Honor. I can do that. The first is Dr. Freeman, Major Freeman. [134]

The Court: Perhaps it might be well for you to conclude the cross-examination first and then plaintiff rests before you make this application, but inasmuch as you want to defer the cross-examination until tomorrow, why you might as well hear this matter as if the plaintiff's case were concluded unless Counsel has an objection.

Mr. Wertheimer: I have no objection, your Honor.

Mr. Deasy: That is Major Norman Freeman—Dr. Norman Freeman who, your Honor appreciates from the testimony here, took part—

The Court: He was the doctor in charge.

Mr. Deasy: He was in charge at DeWitt, and Dr. Leon Goldman is attached to the University of California Hospital and is also the, I think, Chief of Surgery of San Francisco, the City and County

of San Francisco Hospital, who was in charge of the treatment of Miss Canon at that institution while she was there, and Dr. Paul Gleeby, who was also on the staff of the San Francisco City and County Hospital and who was also associated with the treatment afforded by that hospital to Miss Canon.

The Court: Where is Dr. Freeman, is he in San Francisco?

Mr. Deasy: He is; yes, your Honor. He lives in Marin County but he is in San Francisco. These doctors, I understand, are all in San Francisco at the present time but—— [135]

The Court: Why don't you just subpoena Dr. Freeman to come here tomorrow morning if you—so we can conclude this case? If he is here and the other two doctors, they have no testimony to give that would have any bearing on this malpractice unless you are using them as experts.

Mr. Deasy: It was my intention to use them as experts, your Honor, in line with the defense which I outlined in my opening statement which I made at the beginning of the case.

The Court: Is Dr. Freeman still acting with the government or is he in private practice?

Mr. Deasy: He is in private practice, your Honor. These doctors are all in private practice. He has been discharged from the Army, although I think he does some consultations.

The Court: We could dispose of him. Dr. Freeman wouldn't take too long. I think you better



have him here tomorrow morning. Send the Marshal over with a subpoena for him. I know the doctors are busy and I know they have conventions, but we just got to conclude lawsuits, we just can't continue them indefinitely.

Mr. Deasy: Well, I will attempt to have him here tomorrow.

The Court: Of course there is that important legal question that will have to be determined at the end of the plaintiff's case. [136]

Mr. Deasy: There are certain motions.

The Court: Whether or not the plaintiff—the question we have already discussed, the question as to whether there is any evidence of malpractice.

Mr. Deasy: I intend to make a motion in that respect at the conclusion of the case, your Honor. I felt very seriously that in this case that there might not be the necessity for having these doctors all here and I didn't want to put them under subpoena.

The Court: Perhaps in the desire to save time and save everyone's convenience, perhaps we are proceeding more rapidly than we should. I think perhaps the matter better wait until tomorrow when you conclude your examination and the plaintiff's case is finished. You can make your motions and we will then determine the motions and determine whether or not to issue the subpoenas for the doctors. I think that would be the best thing.

Mr. Wertheimer: That is all right with me. Are you calling Dr. Rector?

Mr. Deasy: No, I don't intend to call Dr. Rector.

Mr. Wertheimer: I don't intend to call him.

Mr. Deasy: I don't think it is important. We have his deposition which either one of us could use. He lives in Sacramento which is approximately 100 miles away. I think we might take—read the deposition. [137]

The Court: Well, I think probably we had better let you go today. We will reconvene tomorrow morning at ten o'clock.

(Thereafter, a continuance was taken until Thursday, March 24, 1949, at 10:00 a.m.) [138]

Thursday, March 24, 1949, 10:00 a.m.

The Clerk: Canon versus the United States.

Mr. Wertheimer: Ready.

Mr. Deasy: Ready, your Honor.

Mr. Wertheimer: Do you want her to take the stand?

Mr. Deasy: Yes.

Thereafter,

## MYRTLE CANON

previously sworn, resumed

### Cross-Examination

By Mr. Deasy:

Q. Miss Canon, I think you said yesterday you are 35 at the present time, is that right?

A. I am 36.

Q. You are 36. You were 32 at the time of this

(Testimony of Myrtle Canon.)

operation, is that right?      A. That is right.

Q. Previous to—previous going into service of the Army at the Tormey Hospital, you had been residing in Southern California, is that right?

A. Yes, I resided there in Southern California.

Q. And I think you said you graduated from High School down there about 19—what was it? 1931?      A. Santa Monica Hospital, 1931.

Q. And while you were going to High School there were you [139] living with your folks there, your family there?

A. My family lived there. I worked my way through school, but my family lived down there.

Q. Do you have a number of brothers and sisters?

A. I have three sisters and one brother.

Q. You have three sisters and one brother. Now, you mentioned yesterday working for a number of different doctors in Santa Monica and Los Angeles. Was that while you were going to High School or after you graduated from High School?

A. I was working at Dr. Koski's during the time I was going to High School and afterwards.

Q. You worked for the doctors both during your school time and afterward?      A. Yes, sir.

Q. And the course you took was a business course, you didn't study nursing?

A. No, sir, I was taking up pre-nursing and a business course.

Q. Pre-nursing?      A. Pre-nursing.

(Testimony of Myrtle Canon.)

Q. When did you first become interested in medical matters and becoming a nurse?

A. Well, from early childhood. My mother is a nurse and my aunt is a nurse and I have always been around medicine.

Q. You have been interested in it then since early childhood?

A. Almost as long as I can remember. [140]

Q. —In medicine? A. Yes, sir.

Q. And I think you said that when you worked for these various doctors in Santa Monica and Los Angeles you assisted them in changing dressings on patients, is that right?

A. Yes, and also when I worked for the plastic surgeon which I mentioned, I scrubbed for surgery in his office.

Q. You assisted him in other surgical procedures, did you? A. Yes.

Q. And during that period of time you observed quite a number of patients' dressings and assisted in dressing a number of wounds on different patients? A. Yes, sir.

Q. And during those periods of time when you were working for these doctors, did you keep the records in the doctors' offices of the treatment he gave to patients that came in while you were working there?

A. Most of the time that wasn't under the scope of my duties because they had full time secretaries. I assisted the nurses most of the time.

(Testimony of Myrtle Canon.)

Q. And you also, I believe, testified yesterday that you worked in several hospitals in Southern California before you went to the Tormey Hospital at Palm Springs. You assisted in surgery at those hospitals, is that correct?

A. I didn't assist in surgery. I was a surgical technician [141] actually at California Hospital. I worked as an undergraduate nurse at the Culver City Hospital, but I didn't handle medications because I wasn't an R.N., but I did routine care, baths and that sort of thing.

Q. What is a surgical technician, what do you do as a surgical technician?

A. You take care of instruments in surgery, that is autoclave. You set up the surgery, that is as far as—you don't actually set out the sterile instruments, the nurses do that, but you do supplies and that sort of thing, making up the various packs.

Q. And you liked this work, didn't you?

A. Yes, I did, very much.

Q. And would you say that some of the work you did for these doctors in these hospitals would ordinarily have been done by registered nurses if it were not for a shortage in nurses?

A. Yes, sir. As a matter of fact, during the war there was a shortage of nurses. Since the war now the work that I did is being done by graduate nurses. I was the only person at California Hospital that was allowed to do instruments. I learned



(Testimony of Myrtle Canon.)

all of the names of the instruments, their uses, and watched them being used by surgeons.

Q. And you got that opportunity to do that because there was a shortage of R.N.'s?

A. —And then because my work was highly recommended. [142]

Q. And you found this, the work that you did, such as assisting these doctors and in changing dressings yourself for the doctors quite fascinating, didn't you?

A. Yes. I observed and assisted in changing the dressings. I didn't change the dressings under my own supervision, I mean myself. It was always under supervision.

Mr. Wertheimer: Miss Canon, may I make the suggestion so that in the course of this trial if Mr. Deasy asks you a question, you answer the question and don't volunteer, please.

Mr. Deasy: Well, perhaps the question I asked wasn't quite in accordance with the facts.

Q. In other words, you yourself didn't do the whole job? A. That is right.

Q. —For the doctor, but you helped doctors?

A. That is right.

Q. And you were present and you observed while they were doing the changing of the dressings?

A. Yes, sir.

Q. And you found that very interesting and highly fascinating? A. Yes, sir.

Q. Did you become interested in the progress of

(Testimony of Myrtle Canon.)

particular cases of particular patients in which you were assisting the doctor? I mean, you were interested in following up the case?

A. Yes, I was interested in all phases, yes. [143]

Q. And did you discuss these cases with the doctor for whom you were working?

A. No, sir.

Q. You handled the instruments in the doctors' offices and in these hospitals where you worked?

A. Yes, it was my job.

Q. And you became familiar with the names and the uses of the different instruments?

A. Yes, sir.

Q. And I assume that you were, of necessity, familiar with the fact that the dressings and instruments had to be sterile at all times? A. Yes.

Q. You learned, didn't you, that an infection might well result if the wound came in contact with some object which wasn't sterile?

A. Yes, sir.

Q. I mean the doctors impressed that on you, didn't they? A. Yes, sir.

Q. Now, during the time you worked for these doctors in the hospitals in Southern California, and during the time you worked at Tormey in the hospital at Palm Springs, and at the DeWitt Hospital, you always tried to do your work as conscientiously as possible, isn't that right? A. Yes, sir. [144]

Q. And as a matter of fact, you were willing to work extra time to finish the job that was at hand?

(Testimony of Myrtle Canon.)

A. I always did.

Q. And you always had a strong feeling of loyalty to the person for whom you were working, isn't that so?

A. Yes, I did. I got along well with all of them.

Q. And you always felt badly when you had to leave, for one reason or the other you had to leave the employment of any of these doctors, isn't that right?

A. Yes.

Mr. Wertheimer: Well, I object to that question, your Honor. I don't think it is competent. It is incompetent, irrelevant and immaterial.

The Court: I don't see the materiality of that.

Q. (By Mr. Deasy): Now, going back to the time when you first went to work for the Army at the Tormey Hospital, when was that?

A. December 1943.

Q. 1943?

A. Late December or early January. I believe it was December.

Q. Well, it was about the end of 1943 or the beginning of 1944?

A. That is right.

Q. And at that time were you in good health?

A. Excellent health. [145]

Q. And up until—prior to that date had you ever had surgical attention?

A. Yes.

Q. And what was that for?

A. I had an appendectomy in 1928 and I had an injury to my hand in 1931.

Q. I didn't hear that answer.

(Testimony of Myrtle Canon.)

A. I said I had an appendectomy in 1928 and I had an injury to my hand in 1931 which necessitated surgical treatment.

Q. You got some foreign bodies imbedded, some glass or something imbedded in the hand, isn't that right? A. Yes, sir.

Q. While you were working at Tormey Hospital, you were ill on a couple of occasions, weren't you?

A. Yes.

Q. You had some difficulty in breathing and at one time that required your hospitalization?

A. Yes.

Q. Did you have a tonsilectomy performed at the Tormey Hospital?

A. I had a tonsilectomy performed at the California Hospital.

Q. Was that before you went to work for Tormey? A. Yes, sir.

Q. In September of 1944 you were working at Tormey Hospital, isn't that right, in September of 1944? [146] A. September of 1944, yes.

Q. You had taken sick there at that time?

A. That is right.

Q. With difficulty in breathing, and they had to put you in an oxygen tent? A. Yes, sir.

Q. You were then discharged to go home, isn't that right? A. Yes, sir.

Q. Then when did you first go to the DeWitt Hospital to work? A. Late October.

Q. 1944? A. 1944.

(Testimony of Myrtle Canon.)

Q. Then you were only home with your mother——

A. I was only home for a couple of weeks.

Q. ——for a short time?

A. Just a couple of weeks.

Q. Now, after the operation, the vein ligation in June of 1945 at the DeWitt Hospital, that was on the 14th, wasn't it, of June?      A. That is right.

Q. When did you first get out of bed after the operation?      A. I don't remember.

Q. Was it within a day or two—wasn't it?

A. A couple of days.

Q. They let you up?      A. That is right.

Q. During the period from the date of the operation and the [147] time you were transferred to the University of California Hospital, you weren't in bed all of the time, were you?

A. No, I was ambulatory part of the time.

Q. You were up and about quite a bit at the time?      A. Yes.

Q. And on occasions you bathed yourself, didn't you?      A. Yes.

Q. And during that period you didn't remain on the ward all of the time?      A. No, sir.

Q. You went outside of the ward?

A. I was allowed to.

Q. You went to the portions of the building which were used for civilian personnel?

A. Yes, sir.

Q. And to the P.X.?      A. That is right.



(Testimony of Myrtle Canon.)

Q. Is the P.X. located in the hospital building there?

A. Yes, it is right in the hospital building.

Q. Now, isn't it a fact, Miss Canon, that during the period between the time of the operation and the time that you left the DeWitt Hospital you handled the dressings of your wound repeatedly, isn't that true?

A. No, sir.

Q. And isn't it true that during that period of time you [148] frequently argued with the nurses and objected to their changing the dressings?

A. I argued with the nurses, I admit.

Q. With reference to the changing of dressings?

A. I don't remember what it was about but I remember I did have some arguments with them.

Q. Didn't you feel during the time you were there at the DeWitt Hospital, Miss Canon, after the operation, that the nurses weren't properly attending to their duties in taking care of you from time to time?

A. At times, yes.

Q. And didn't the nurses tell you from time to time while you were there that you were not to touch the bandages and that you were not to touch the wound?

A. Yes. I never did.

Q. Didn't they tell you not to?

A. Yes, sir.

Q. And didn't they accuse you?

A. (Interrupting) They tell every patient that.

Q. And didn't they accuse you of doing it?

A. Yes, they did.

(Testimony of Myrtle Canon.)

Q. —On several occasions?

A. Yes, they did.

Q. Now, during the time you were at the University of California Hospital, during that period of time, did you touch [149] the wound or interfere with the dressings at any time?

A. No, sir, I never did.

Q. And during the time you were at the San Francisco Hospital or any of these other institutions, did you touch the wound or handle the dressing? A. I never have.

Q. Didn't the people at the University of California Hospital, accuse you of handling the dressings? A. They did.

Q. And at the same hospital, the San Francisco Hospital they put you in a cast?

A. That is right.

Q. And they told you that the cast was to keep you from handling the wound, isn't that right?

A. That is right.

Q. And that is the reason—they told you that is the reason they had to put these three casts one after another on you, is that so? A. Yes.

Mr. Deasy: No further questions.

Mr. Wertheimer: Just a minute. I don't think I have any more questions, your Honor. I guess I don't have any questions, your Honor.

Mr. Deasy: There are some portions of the hospital records, your Honor, that the—of the records

which were Plaintiff's Exhibit 3 that I would like to read to the Court. [150]

Mr. Wertheimer: Well, that is in connection with the cross-examination of Miss Canon, is it? I am a little unfamiliar with this procedure, your Honor. Is Mr. Deasy now putting in his case?

Mr. Deasy: No, I am not putting in my case, Mr. Wertheimer. Reading portions of the record——

The Court: I don't think you need to do that. Whatever privilege one Counsel has, of course the opponent has the right to continue. It is a portion of the record.

Mr. Wertheimer: I am the last to dispute that, your Honor. If that is done, then I think Mr. Deasy is proceeding to put in his case. I mean, he has finished his cross-examination.

The Court: I think he may, in connection with the examination and testimony of the plaintiff, call attention to any of the hospital records and the subject matter of the matters that were subject to the cross-examination.

Mr. Wertheimer: I certainly think that is not proper.

Mr. Deasy: That is what I have in mind, to call the Court's attention to certain portions of the exhibit which is in evidence.

The Court: Very well.

Mr. Deasy: Rather than asking the lady about it. Isn't this—rather than point them out to her, I just want to point them out to the Court. [151]

Mr. Wertheimer: I wish to say I have no ob-

jection to Mr. Deasy doing that, but I wish to say this to the Court: Either it is an argument or else Mr. Deasy is now putting in his case and I will warn that it will be my position if he does so that any motion similar to the—like a nonsuit, and all the rest are unavailable to him when he starts to put in his own evidence.

The Court: Well, I will allow counsel——

Mr. Deasy: I had in mind, your Honor, conserving time and the fact——

The Court: I think the procedure is perfectly proper.

Mr. Deasy: I can ask the lady or I can point those out to Miss Canon and say that “Isn’t it a fact that on a certain date you did so and so”?

The Court: It has been already asked and that has been admitted in evidence as a Plaintiff’s exhibit, and of course Counsel has the right——

Mr. Wertheimer: I don’t dispute that, your Honor.

The Court: ——has a right to do it without putting in his own case. It is part of your case and he can call attention to such matters as he wishes to.

Mr. Wertheimer: Just so long as my objection is clear that is all.

The Court: Very well, go ahead.

Mr. Deasy: I have another copy of this record, your [152] Honor. I don’t know if they are in the same order. These pages are numbered after a fashion. I took my copy, which is a certified copy, home last night and went through it very carefully

so that I could read without taking too much time the portions I wanted to point out to the Court. If there is any objection to my reading from the—from my own copy, I will offer it in evidence.

The Court: You might give—let Counsel follow you on the other and then there wouldn't be any question.

Mr. Deasy: The thing I had in mind is they may not be in the same order. I don't want to fumble through that when I can save time in here.

Mr. Wertheimer: I have no objection to Mr. Deasy doing that. My suggestion is he show me the courtesy that I may have overlooked when I was reading it. In other words, referring to the paper.

Mr. Deasy: My intention is to show things the plaintiff did. I haven't got a page number for counsel to follow. The record shows that the operation took place on January 14, 1945.

Mr. Wertheimer: June the 14th.

Mr. Deasy: Pardon me, June the 14th, 1945.

Now, I am referring at first, Counsel, to a page which is numbered 94. There are two sheets numbered there.

Mr. Wertheimer: That confuses me. [153]

Mr. Deasy: This is it.

Mr. Wertheimer: I think I have it.

Mr. Deasy: This is the nurses' chart immediately following the operation. The entries on January 15 indicate that—

Mr. Wertheimer: June the 15th.

Mr. Deasy: Pardon me. I can't read my own



writing. June the 15th indicate that the lady was up, that she was walking or attempting to walk on that date. I am referring to the time as June 15 at 10:45 when she was given medication for pain following first attempt to walk. That was one day following the operation.

Mr. Wertheimer: May I suggest this is very brief, Mr. Deasy. You read precisely what he says instead of paraphrasing.

Mr. Deasy: Well, it says:

“ASAGR-10.” I can’t read that stuff. It says: “For pain following first attempt to walk.” That is the item I am calling attention to. Then on page 95 under date of June 18 there is the entry “Up and to BR—” which I assume is the bathroom—“with ease. Now has Ace bandage reapplied. Appetite good. Patient disturbed over being moved out of private room. Fussed and cried. Found on Ward 118. Returned to ward by night supervisor. Left back door towards Officers’ Club—” that is on the 18th, four days after the operation. On page 97 there is an entry under June 23 that she— [154] showing that she was up and to the bathroom and that on the same page under date of June 24 there is an entry that she refused to have saline packs until after the doctor had seen her on June 26.

Mr. Wertheimer: Excuse me, Mr. Deasy. You said on June 23rd there was an entry.

Mr. Deasy: June 24, Counsel, it says routine care.

Mr. Wertheimer: I see. All right.

Mr. Deasy: "Refused to have saline packs until seen by Lt. Rector." I am reading these to show, your Honor, the lady wasn't in bed during that period immediately following the operation. There are entries under June 27 also that—on page 98 showing she was up and about.

On June 28 on page 98 that—showing that she was up and sitting on the porch.

On page 99 under date of July 1 there is an entry reading "Major Freeman visited soon after patient developed hysteria which lasted close to two hours manifested by sobbing and severely—," etc.

On July 2nd, page 100, there is an entry that "was apparently in good humor until about 0900 when she began suffering for no apparent reason. She was instructed to go to the bathroom and take a sponge bath which she did and returned to her bed seemingly happy again, but in about 15 minutes was again weeping." Under date of July 3 hysterical [155] for about 45 minutes. Very belligerent, threatened to slap and hit the nurse.

On page 101 under date of July 5 there is an entry, "Refused to have dressings changed."

Another 1:15 in the morning, July 5, morning of July 6, patient stated she is unable to sleep there up and walking about the ward. That is Thursday night.

On July 9, on page 102 there is an entry that—showing that she was coming—she was up to take a sponge bath and that she apparently felt fine. Coming back from the latrine she yelled and ap-

parently fainted. They gave her spirits of ammonia and revived her.

There are continued references to hysterical conduct and to fits of temper through here. I am not going to read all of these, your Honor. But there are numerous entries where she refused to allow the nurses to change the dressings.

On July 19 on page 106 there is the following entry: "Patient continually rubbed and pulled the incision in spite of constant warnings not to do so."

On page 107 there is the entry: "Patient continues to constantly rub and pull the incision and dressings. She has been repeatedly instructed not to do this.

On page 114—on page 109 there is an entry reading as follows:

"Has been crying and sobbing and rubbing leg since [156] 2100."

The Court: What date?

Mr. Deasy: This is July 26, your Honor.

"Becoming more hysterical every moment. Apparently having intense unbearable pain according to her description and sobbing accusations. Nembutal given patient immediately (underscored). Stopped crying apparently. Pain became unbearable, sleeping soundly within 15 minutes after taking Nembutal."

Mr. Wertheimer: I move to strike out the entry which is obviously an opinion or a conclusion. Anything that comments on the facts is——

Mr. Deasy: I am reading an entry just as it is written.

The Court: It states the fact, doesn't it? It says given a tablet to sleep.

Mr. Wertheimer: I guess you are right. Withdraw the objection.

Mr. Deasy: On page 114 under date of August 7—

Mr. Wertheimer: Just a moment, until I find that place.

Mr. Deasy: This is August 7th at 0100. That is one o'clock a.m. This entry explains "crying loudly, found tampering with dressing and wound. Moderately large amount of bloody drainage on bottom and top sheet. Dressings clean—" clear or clean, I can't read it, but it is — "aspirin given, quiet, sleeping." [157]

On page 128 under date of September 15—

Mr. Wertheimer: Just a moment, I haven't found that.

Mr. Deasy: 128. The pages are not entirely in chronological order, your Honor.

Mr. Wertheimer: I understand that. The numbering here is—

Mr. Deasy (Interrupting): This item appears under September 15: "Awake but asked for no medication. Had covers pushed down. Looks like SO trunk and part of thighs exposed. Said 'I am cold but I was so hot.' "

On page 145—pardon me, page 140—page 140 and 141—these are reversed in chronological order.

What I will read from 141 starting at paragraph 3, the following entry appears:

“Lt. Rector on ward to repack wound. Patient apparently in sound sleep. Nurse was asked what hot pack on left arm was for—replied some fluid had scraped into tissue from intravenous glucose 5 per cent NS during the night. Nurse was remarking that her arm was somewhat swelled. She has kept us running all day with hot packs and hot water bottle. Patient immediately wide awake. Began throwing anything within reach at nurse and yelling and crying she hated the nurse and wished the nurse had similar stab wound and open incision that she would like to stuff her nurse’s leg full of gauze. Frequently screamed ‘get her out of here.’ When told by [158] Lt. Rector she must have something to do with the feud between herself and nurse, she continued sobbing and yelling that they, the nurses, were all just mean and hated to do anything for her. Patient thrashed about at beginning of dressing disarranging layout—laid out equipment creating danger of contaminating sterile set. Civilian worker reports patient in civilian latrine with door locked. Nurse knocked and called to patient until 1905—this entry is 1850 until 1905 before patient came out. Patient in latrine wailed that ‘I am bleeding, I am bleeding,’ with no attempt to open door until time stated. Wound dressing wasn’t examined by nurse but patient immediately began to dress and had previously threatened to leave here during change of dressing. Patient



dressed, ate piecemeal in ward kitchen. Refuses supper tray. Left ward, SOD notified, patient said 'I am going to Auburn.' " That entry is under 1925, the time, and under time of 2010 "Patient returned to ward apparently having spent half-hour at the PX. Patient was seen at PX by day nurse very depressed sitting on chair in room when back on ward."

Mr. Wertheimer: If the Court please, with respect to that entry. I will move it be stricken as being incompetent and immaterial. A civilian worker reporting the patient in the civilian latrine with door locked and crying is hearsay. I think the only thing that is admissible in the [159] hospital records is the reports of the fact.

The Court: Well, of course hospital records themselves are a violation of the hearsay rule. There is no doubt about that, but they are allowed as a violation of the hearsay rule. If there is something that is subject to an ordinary notation in the record of the hospital as to the conduct of the affairs of the hospital and the patient in there. The things that are excluded are opinions as to conditions and diagnoses and things where there is more harm to be done by admitting such opinions because there is no opportunity to cross-examine. But such a factual matter as whether or not a person went to the lavatory or not, or whether someone saw her going to the lavatory or not, while they are hearsay are admissible if they are a part of the hospital records.

Mr. Wertheimer: I think, your Honor, that the rule is——

The Court (Interrupting): Well, I am not going to waste time arguing about such a trivial matter as this. Overruled. It isn't of any importance that I can see in the case anyhow.

Mr. Deasy: Under date of September 1945 on page 140, this entry appears:

“Rector visited—Lt. Rector visited patient, asked to have room door shut continuously, as have two to four days; although told by Lt. Rector to stay in bed goes to [160] latrine and spends ten minutes to half an hour one time or three times per a.m. and p.m.”

Now, on page 145 this is under date of August 25, this following occurs: “As patient's temperature was 99.0 nurse gave another thermometer and came back shortly. Thermometer read 104.4. Patient upset at having rectal reading, thrashed about until knocked radio off. Rectal reading 98.8.”

Now, under date of August 21 on page 146 there are entries showing that she was walking in the halls and sitting outside the ward premises.

On October 21—this is on page 59, Counsel, it goes back. On the date of October 21, this is—this entry appears:

“Small amount of dry red blood at upper outer corner of wound. Vaseline gauze appeared to be tampered with.”

On page 61 on October 26——

Mr. Wertheimer: (Interrupting) I would, your

Honor, I would again move that the part "appeared to be tampered with" be stricken as a conclusion and opinion.

Mr. Deasy: It is a notation of what she observed.

Mr. Wertheimer: Every notation is admissible under the business entry rule. The rule states according to the Code, the California Code of Civil Procedure, the report of a fact, condition or event.

Now, it is true records themselves are hearsay, but if that interne excluded other hearsay or opinions or the like or if that report, for instance—suppose in the record it appeared that John Doe said that John Roe said that——

The Court: (Interrupting) We are not concerned with theoretical cases. It is an actual situation that confronts us with respect to the state of this record. I will overrule the objection. The objection here goes more to the weight rather than to the admissibility of this testimony. I will let it in because there is other evidence, other statements in the record of previous similar things so that particular entry, the objection is more to its weight than its admissibility.

Mr. Deasy: On page 61, under October 26, there is the entry:

"Patient states she is going to remove tubes and get out of bed. Very uncooperative. Out on the porch." That was on page 61, Counsel.

Page 62, under October 27, at the bottom of the page appears the entry:

“Patient quite uncooperative, emotional, threatens to get out of bed.”

On page 63, under date of October 29, this entry appears:

“Large amount of bright red blood oozing from wound. Good night dressing appeared to be tampered with. Small [171] portion of wound exposed.”

Mr. Wertheimer: Same objection, your Honor.

The Court: Same ruling.

Mr. Deasy: On page 64 under date of October 30 this entry appears:

“Patient refused to let nurse see dressing. Patient appeared quite nervous, profuse diaphoresis. Bed clothes and cradle were on sideways. Patient became excited, struck nurse on chest and arms with insistence of nurse upon seeing dressing, patient then stated she was up out of bed and had walked to latrine. Ramp supervisor notified to see patient. Dressing placed over wound and reinforced. A moderate amount of bright red blood. It indicates—became hysterical, was forced to stay in bed.”

On page 76 the following entry appears under November 15:

“Patient became hysterical. Began getting out of bed. When put back in bed patient struck WAC on chest and arms. Patient became worse—patient’s leg became worse and twisted in cradle. SOD notified and her dressing reinforced by Captain Zeigler and Colonel Pendegrast notified. Here patient began to be calmer now but still has wild psychotic glare.”

Next page 77, which is under date of November 16, the entry appears:

“Patient out of bed crying, insisted upon leaving hospital at once. Locked door. Patient returned to bed at 1800.”

The Court: Is that all you wish to call attention to at this time?

Mr. Deasy: Yes, your Honor.

The Court: We will take a brief recess then.

(Short recess.)

(After recess.)

Mr. Wertheimer: I have, your Honor, two entries to read from this hospital record and then I am through with my part of the case, your Honor. Reading No. 43, Mr. Deasy, it is called Pathological examination of tissue.

Mr. Deasy: Yes.

Mr. Wertheimer: This pathological examination of tissue is signed by a gentleman by the name of Madoff who is Chief of the Laboratory Service. It is dated August 23, 1945.

“Saphenous vein ligation. Clinical history —” first it says, “Saphenous vein ligation 12 June 1945. Wound in fold of groin broke down and has failed to granulate or heal. Has a continuous bloody discharge.”

Then there is the pathological report. I won't read that part that is described as gross which describes apparently [173] a specimen in part. Then the microscopic shows some granulation tissue which



is predominant hemorrhagic. There are a number of areas within the tissue that show focal degeneration and a subacute and inflammatory reaction. A number of the blood vessels show swelling and fibrinoid degeneration of the walls and occasional small multi-nucleated giant cells are seen. Diagnosis granulation tissue, hemorrhagic.

Then the second and the only other one I want to read is the pathological examination of tissue dated October 3, 1945, also signed by Irving Madoff, Lt. Col. I may have demoted him to the grade of Lt. a moment ago. He is a Lieutenant Colonel and Chief of the Laboratory service.

“Microscopic: Section consists of skin subcutaneous tissue, and underlying fat. The microscopic picture is essentially similar to that seen in previous excisions. There is a moderately severe, chronic inflammatory reaction in the subcutaneous tissue and fat. In the adipose tissue there are scattered small focal areas of necrosis and hemorrhage, as well as a few larger hemorrhagic areas. There is a considerable capillary dilatation and congestion throughout the tissue. The diagnosis is peniculitis, hemorrhagic, chronic.”

Mr. Wertheimer: That is the Plaintiff's case, your Honor. [174]

Do you want to argue on the motion?

Mr. Deasy: At this time, your Honor, I would like to move for a dismissal of the action upon the ground that the evidence does not show—first that the operation and subsequent treatment referred to

in the evidence and in the complaint were performed or given by any employees of the United States while acting in the line of duty or within the course and scope of his employment; secondly upon the ground that the evidence does not—fails to show any act or omission either negligent or wrongful on the part of any employee of the United States acting in the scope of his employment or in the line of duty.

(Thereafter motion argued by Counsel for both sides.)

The Court: The order will be then that the motion will be taken under advisement and the trial will be continued until—I will continue the trial until April the 8th.

Mr. Wertheimer: That is satisfactory, your Honor. Thank you. [175]

State of California,  
City and County of San Francisco—ss.

I, B. E. O'Hara, Official Reporter Pro-tem, of the District Court of the United States for the Northern District of California, Southern Division, do hereby certify that the foregoing pages 1 to 175, inclusive, contain a full, true and correct transcription of my shorthand notes of the testimony given and proceedings had on the trial in said Court of the action entitled *Myrtle Canon, Plaintiff, versus The United States, Defendant*, and numbered 27473-G in the files of said Court; and that said

transcript includes the testimony offered or taken, evidence offered or received, and all rulings, acts, instructions or statements of the Court, also all objections or exceptions of Counsel, and all matters to which the same relate.

In Witness Whereof, I have hereunto set my hand this 3rd day of December, 1949.

/s/ B. E. O'HARA,  
Reporter.

[Endorsed]: Filed December 7, 1949. [176]

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[Endorsed]: No. 12394. United States Court of Appeals for the Ninth Circuit. Myrtle Canon, Appellant, vs. United States of America, Appellee. Transcript of Record. Appeal from the United States District Court for the Northern District of California, Southern Division.

Filed November 4, 1949.

/s/ PAUL P. O'BRIEN,  
Clerk of the United States Court of Appeals for  
the Ninth Circuit.

In the United States Court of Appeals  
for the Ninth Circuit

No. 12394

MYRTLE CANON,

Appellant,

vs.

UNITED STATES OF AMERICA,

Respondent.

STATEMENT OF POINTS UPON WHICH  
APPELLANT INTENDS TO RELY ON  
APPEAL AND DESIGNATION OF PARTS  
OF THE RECORD NECESSARY FOR CON-  
SIDERATION THEREOF

To the Honorable William Denman and to the  
Honorable Associate Justices of the United  
States Court of Appeals for the Ninth Circuit:

Appellant respectfully states that the following  
are the points upon which appellant intends to rely  
on appeal, to wit:

1. The District Court erred in granting a judgment of dismissal of plaintiff's action;
2. The judgment of dismissal is against law;
3. The judgment of dismissal is against evidence;
4. Colonel William Smith, Commanding Officer of DeWitt General Hospital, at Auburn, California, was acting in the scope of his office or employment and in line of duty in admitting plaintiff to the

DeWitt General Hospital as a patient, and in authorizing an operation for varicose veins to be performed upon her in that hospital and in authorizing the use of the facilities of said hospital for such operation and for post-operative treatment of plaintiff;

5. Dr. E. William Rector was empowered and was acting in the scope of his office or employment and in line of duty in performing an operation upon plaintiff on June 14, 1945 and in providing plaintiff with post-operative surgical and medical care or treatment at DeWitt General Hospital;

6. Dr. Norman Freeman was empowered, and was acting in the scope of his office or employment and in line of duty in providing plaintiff with surgical or medical care or treatment at DeWitt General Hospital;

7. The nurses, doctors, attendants, or other employees of the United States, employed or attached to DeWitt General Hospital during the time plaintiff was a patient at said hospital, were empowered to, and were acting in the scope of their offices or employment and in line of duty in providing plaintiff with surgical, medical, hospital, nursing or other care, treatment or services in DeWitt General Hospital;

8. Under the law of the State of California, the United States of America, if a private person, would be liable to plaintiff for damages on account



of the actions of its agents, servants and employees in this case.

Appellant designates the following documents and parts of the record, which appellant thinks necessary for the consideration of the foregoing points on appeal, to wit:

1. All of the Clerk's transcript of record;
2. Only the following portions of the Reporter's Transcript:
  - A. Page 2, line 1, to and including page 26, line 20;
  - B. Page 78, line 21, to and including page 80, line 6;
  - C. Page 86, line 22, to and including page 87, line 3.

Dated: December 13, 1949.

Respectfully submitted,  
HALLINAN, MacINNIS  
ZAMLOCH,  
RALPH WERTHEIMER,  
/s/ RALPH WERTHEIMER,  
Attorneys for Appellant.

Receipt of copy acknowledged.

[Endorsed]: Filed December 14, 1949.

[Title of Court of Appeals and Cause.]

RESPONDENT'S DESIGNATION OF ADDITIONAL PARTS OF THE RECORD NECESSARY FOR CONSIDERATION OF APPEAL

To the Honorable William Denman and to the Honorable Associate Justices of the United States Court of Appeals for the Ninth Circuit:

Respondent respectfully designates the following additional documents and additional parts of the record which respondent believes necessary for the consideration of this appeal, to-wit:

1. Any and all portions of the Reporter's Transcript not heretofore designated by Appellant.

2. Any and all exhibits filed in the trial court by either Appellant-plaintiff or Respondent-defendant which have been designated in Appellant's designation of the record on appeal filed in the District Court or have been designated in Respondent's supplemental designation of the record on appeal filed in the District Court.

3. Any and all portions of the record on appeal designated by appellant in his "Designation of Contents of Record on Appeal" filed November 3, 1949, in the District Court, which appellant may have omitted from his "Statement of Points upon which Appellant Intends to Rely on Appeal and Designation of Parts of the Record Necessary for Con-

sideration thereof," dated December 13, 1949, and filed with the Court of Appeals.

Dated: December 23, 1949.

/s/ FRANK J. HENNESSY,  
U. S. Attorney.

/s/ CHARLES O'GARA,  
Asst. U. S. Attorney,  
Attorneys for Respondent.

Affidavit of Service by Mail attached.

[Endorsed]: Filed December 23, 1949.

[Title of Court of Appeals and Cause.]

ORDER THAT PORTIONS OF RECORD  
NEED NOT BE PRINTED

Good cause appearing therefor,

It Is Hereby Ordered that all of the exhibits filed in the trial Court in this cause and heretofore transmitted to the Court of Appeals for the Ninth Circuit need not be printed as part of the Record on Appeal but may be considered in their original form and in such original form shall constitute a part of the Record on Appeal; provided further, that excerpts from said exhibits may be printed as appendices to either Appellant's or Appellee's briefs herein.

Dated: This 16th day of January, 1950.

/s/ WILLIAM DENMAN,  
Judge of the United States Court of Appeals for  
the Ninth Circuit.

/s/ WILLIAM HEALY,

/s/ HOMER BONE,

Judges, U. S. Court of Appeals  
for the Ninth Circuit.

[Endorsed]: Filed Jan. 16, 1950.

[Title of Court of Appeals and Cause.]

REQUEST FOR ORDER RE EXHIBITS

City and County of San Francisco,  
State of California—ss.

Charles O’Gara, Assistant United States Attorney,  
being first duly sworn, deposes and says:

That he is the Assistant United States Attorney  
with Frank J. Hennessy, United States Attorney,  
representing the United States of America, Appel-  
lee in Myrtle Canon, Appellant v. United States,  
Appellee, appeal, case No. 12394, in the United  
States Court of Appeals for the Ninth Circuit;

That he has examined all the exhibits on file in  
this appeal with said Court of Appeals and finds  
them to consist principally of United States Army  
Hospital records, so voluminous that printing them  
as part of the Record on Appeal would involve  
great expense and loss of time to the Appellee, and  
he therefore recommends and requests that said  
Court of Appeals order that said exhibits may be  
considered in their original form as part of said  
record on appeal.

/s/ CHARLES O’GARA,  
Asst. U. S. Attorney.

Subscribed and sworn to before me this 13th day  
of January, 1950.

/s/ PAUL P. O’BRIEN,  
Clerk, U. S. Court of Appeals  
for the Ninth Circuit.

[Endorsed]: Filed January 16, 1950.



No. 12,394

IN THE

United States Court of Appeals  
For the Ninth Circuit

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MYRTLE CANON,

vs.

UNITED STATES OF AMERICA,

*Appellant,*

*Appellee.*

APPELLANT'S OPENING BRIEF.

---

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*On the Brief.*

FILED

JUN 22 1950

WILL R. DENISON



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No. 12,394

IN THE

**United States Court of Appeals  
For the Ninth Circuit**

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MYRTLE CANON,

*Appellant,*

VS.

UNITED STATES OF AMERICA,

*Appellee.*

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**APPELLANT'S OPENING BRIEF.**

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**STATEMENT OF PLEADINGS, JURISDICTION AND FACTS.**

Plaintiff brought this action under the Federal Tort Claims Act (28 U.S.C. *et seq.*, prior to its codification and re-enactment as 28 U.S.C. 1291, 1346(b), 1402(2), 1504, 2110, 2401 (b), 2402, 2411, 2412 (c) and 2671-2680, hereinafter referred to, for convenience as the Tort Claims Act), to recover damages for personal injuries.

The complaint (Record p. 2) alleged that plaintiff was operated upon for varicose veins, and afforded post-operative treatment, at DeWitt General Hospital, a hospital operated by the War Department of the United States of America; that the doctors and nurses who operated on plaintiff and gave her such

post-operative treatment were acting within the scope of their employment in so doing; that such operation and such treatment were negligently done, by reason of which negligence plaintiff developed a phagedenic ulcer, which is still unhealed. The answer was a general denial.

The case was heard at San Francisco, California on March 22, 1949, before the Honorable Louis Goodman, District Judge, sitting without a jury. At the close of the plaintiff's case, the Honorable District Court took under submission defendant's motion for a dismissal, which motion was granted, on grounds which appear in Judge Goodman's findings of fact, conclusions of law, and written opinion, on April 8, 1949.

Findings of fact, conclusions of law, and a written opinion were filed (Record pp. 9, 15) and judgment was entered (Record p. 25) on August 30, 1949, on the ground that the doctors and nurses upon whose negligence plaintiff based her cause of action, were not acting within the scope of their employment by the Federal Government in treating plaintiff. Plaintiff's notice of appeal was filed September 28, 1949, within the time allowed by law.

Jurisdiction of the District Court arises from the Federal Tort Claims Act, and jurisdiction of this Court arises under 28 U.S.C. Sec. 225 to review the final judgment of the District Court.

Plaintiff Myrtle Canon, a civilian employee of the War Department, stationed at DeWitt General Hospital, an Army hospital ten miles from Auburn, Cali-

fornia, was admitted as a patient to DeWitt General Hospital by order of its commanding officer, Colonel Smith, for surgical treatment of varicose veins, and was operated upon at DeWitt General Hospital by Army surgeons on June 14, 1945.

Plaintiff was a medical secretary, employed at the time of her admission, as secretary to the chief of the vascular surgery section of the hospital. She had been employed in a clerical capacity (Record pp. 41, 42, 43) in other Army hospitals prior to her employment at DeWitt, and had suffered from varicose veins, which (Record p. 45) grew worse during her employment by the Army.

Prior to her admission to the hospital, she had requested that her resignation be accepted so that she might seek surgical relief for her condition in San Francisco. Her resignation was refused by Colonel Stark, head of the surgical section of the hospital, who stated that he had no replacement for plaintiff, and needed her experience, since personnel was difficult to obtain (Record pp. 45, 46). Colonel Stack offered plaintiff surgical treatment at DeWitt General Hospital, so that her work would suffer as slight an interruption as possible (Record pp. 46, 47). Plaintiff was admitted by Colonel Smith under Army Regulation 40-590, sec. 6(b) (13) (Plaintiff's Exhibit 3, page 1), as a civilian employee of the Federal Government who had contracted an occupational disease in the performance of her official duties.

Plaintiff underwent surgery for varicose veins, and post-operative treatment at DeWitt General Hospital.

An infection of the surgical wound developed because of the negligence of the operation and post-operative care, which caused the development of a phagedenic ulcer; plaintiff has been bed-ridden and incapacitated from the time of her operation to the present by this ulcer, and will continue to be so for an indefinite time to come, as well as being subjected to the necessity of procuring expensive medical treatment, and of undergoing many operations, for the said ulcer.

The dismissal was granted the Government in this case on the sole ground that plaintiff's admission to DeWitt General Hospital was unauthorized by A.R. 40-590, and that therefore the acts of the doctors and nurses who operated on her and treated her were outside the scope of their employment.

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### **QUESTION PRESENTED.**

The principal questions presented here are: 1. whether the District Judge erred in finding that the acts complained of were outside the scope of employment of the employees who performed them, and 2. whether the District Judge erred in finding that plaintiff's admission to DeWitt General Hospital was unauthorized.

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### **SPECIFICATION OF ERRORS.**

The District Court erred:

1. In finding that Dr. William Rector, Dr. Norman Freeman, and the doctors, nurses, attendants or other employees of the United States attached to, or



assigned to DeWitt General Hospital were not authorized to furnish plaintiff with surgical or post-surgical care, and were not acting within the scope of their employment by the Federal Government in furnishing such care.

2. In finding as a fact that Colonel William Smith was not authorized to admit plaintiff to DeWitt General Hospital.

3. In granting defendant's motion for dismissal.

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## I.

### **"SCOPE OF EMPLOYMENT" MUST BE DECIDED UNDER CALIFORNIA LAW.**

The preliminary question of the law to be applied to the question raised by the instant case merits but little discussion.

The words of the Tort Claims Act themselves provide the primary authority for the proposition that it is California law to which the Court must look for a definition of the "scope of employment" of the Federal employees whose negligence is here complained of.

Section 1346 (b) of U.S.C.A. Title 28 provides recovery for:

"\* \* \* personal injury or death caused by the negligent act \* \* \* of any employee of the Government while acting within the scope of his employment under circumstances where the United States, if a private person, would be liable to the claimant \* \* \* *in accordance with the law of the place where the act or omission occurred* \* \* \*." (Italics supplied.)

In *U. S. v. Eleazer*, 177 Fed. (2d) 914, at page 917, it is held, under the Tort Claims Act, that "scope of employment" is to be decided under the law of the place where the negligent act was done, citing other Circuit Court opinions decided under the Act. See also this Court's opinion in *Murphey v. U. S.*, 179 Fed. (2d) 743. No decision has been found holding otherwise, and since there is no Federal common law, and no Federal definition of "scope of employment" no other source for such authority than local law is possible.

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## II.

### **THE DOCTORS AND NURSES WHO TREATED PLAINTIFF WERE ACTING WITHIN THE SCOPE OF THEIR EMPLOYMENT.**

The basic question in this case is whether the doctors and nurses who operated on plaintiff and treated her after her operation were acting within the scope of their employment in so doing.<sup>1</sup>

What act could be more clearly within the scope of employment of the medical staff of a hospital than the acts here complained of? These doctors and nurses were doing precisely what they had been hired to do, in the hospital in which they had been hired to work, using the facilities furnished them by their employer for such work, during the hours in which they were on duty, with the purpose of carrying forward their

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<sup>1</sup>Whether or not Colonel Smith, the Commanding Officer of the hospital, was within the scope of his employment in admitting plaintiff is not the question here; no negligence on his part is alleged as a ground for recovery.

employer's enterprise, and not in furtherance of any purpose of their own.

The *Restatement of Agency*, sec. 229, sets forth the generally accepted tests of "scope of employment", which are those enumerated above—use of the employer's facilities, performance of kind of work the employee was hired to do, and the performance of such tasks with the purpose of aiding the employer or carrying forward his business. The cases cited in the *California Annotations* to the cited *Restatement* section show beyond question California acceptance of these tests, as tests of the extent of "scope of the employment".

Particular attention is directed to the last test, which has been recognized as crucial—whether or not in doing the act complained of, the employee had the purpose of furthering his own ends, or the ends of his employer.

In *Stansell v. Safeway Stores*, 44 Cal. App. (2d) 822, a case involving an assault by a store manager on a customer, the Court says:

"\* \* \* liability still exists, even if the servant's act is malicious or wilful, if the act is one which is done *in furtherance of the purpose of the employment.*" (Italics supplied.)

See, also, *Andrews v. Seidner*, 49 Cal. App. (2d) 427, a similar case.

Since neither the doctors nor the nurses whose negligence injured plaintiff were on a frolic of their own, or had any other purpose in their care of plain-

tiff than the furtherance of the ends of the Federal Government, they must be held to have been acting within the scope of their employment in so acting.

It is submitted that the error committed in this case is caused by a confusion between two concepts in the law of agency, "authority" and "scope of employment", confusion which these California cases should dispel.

It is clear from these cases, and from *Restatement of Agency*, Sec. 230, that the *authority* of employee to do a particular act, or his lack of *authority* to do that act, is only important as between himself and his employer. It has no bearing on the relationship between his employer and the outside world. It is, in fact, a commonplace of agency law, as shown by the cases cited, that even if an employee has been expressly forbidden to do a particular act, the act may yet be within the scope of his employment, and his doing the act may yet, therefore, subject his employer to tort liability to third persons injured thereby.

It should be pointed out that nowhere in the cases is "authority" or lack of it used as a measure of scope of employment, or even as one of several tests for the extent of scope of employment. Yet in this case (see Record pp. 12, 13, 14) the District Court has made *authority* the measure of *scope of employment*.<sup>2</sup> If this confusion is cleared away, and the cor-

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<sup>2</sup>It should be pointed out here that the cases cited in support of the District Court's opinion are all cases dealing with the power of an agent to bind the federal government to a *contract*, a field of agency law in which "authority" is the key question (Transcript, p. 12, bottom).



rect tests applied to the question in this case, the *scope of the employment* of these Federal employees must be held to have clearly included the acts here complained of.

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### III.

#### THE FEDERAL GOVERNMENT SHOULD BE TREATED NO DIFFERENTLY THAN A PRIVATE PERSON IN THIS REGARD, UNDER THE FEDERAL TORT CLAIMS ACT.

The argument has been made that the scope of employment of a Federal employee, under the Tort Claims Act, is limited to the acts which he has the "authority" to do, because of the peculiar nature of the Federal Government.

With all due respect to the District Court whose action in this case is founded on this position, the Tort Claims Act itself, its legislative history, and the cases decided under it all say otherwise.

The Act itself, twice in two adjoining sentences (28 U.S.C.A. Sec. 1346 (b)), provides liability for the United States *as for a private person in the same circumstances*. This provision of the Act explicitly equating the Federal Government and a private person in the same circumstances is underlined by the fact that every committee report accompanying the Tort Claims Act or its predecessors specifically picks out for mention this feature of the Tort Claims Act. See Sen. Rep. 1400, 79th Cong. 2nd Sess., which accompanied this Act, Sen. Rep. 1196, 77th Cong. 2nd Sess., and House Rep. 2428, 76th Cong. 3rd Sess.



See, also, *Aetna Ins. Co. v. U. S.*, ..... U.S. ...., 70 S. Ct. 207, which holds that the United States must defend suits by a subrogee exactly as a private person must; the Supreme Court states, in this connection (70 S. Ct. 215):

*“The broad sweep of its (The Tort Claims Act) language assuming the liability of a private person, the purpose of Congress to relieve itself of consideration of private claims, and the fact that subrogation claims made up a substantial part of that burden, are also persuasive that Congress did not intend that such claims should be barred.”*

The Court held that subrogated claims may be sued on, in spite of the fact that by so holding they may have subjected the Government to two suits on a single claim.

Since a private person is not protected from tort liability arising from an employee's unauthorized act, the Federal Government should not be; it is the clear intent of Congress that for these purposes, the Federal Government must be treated as a private person.

Exact authority on this point is furnished by *Oman v. U. S.*, 179 Fed. (2d) 738.

In that case, plaintiff alleged that a Federal employee wrongfully refused to cancel certain grazing rights granted to his predecessor in title, and that the same employee encouraged other grazers to infringe grazing rights which were plaintiff's. Action against the Federal Government was brought under the Tort Claims Act, and the Government demurred.

The Government's demurrer was on the ground that the acts complained of were either discretionary, which barred tort liability under a specific exception contained in the Tort Claims Act, or, if not discretionary, were unauthorized, and therefore were outside the scope of the employee's employment.

The 10th Circuit reversed an order sustaining this demurrer, holding that the acts were not discretionary, but that it was mandatory for the employee to revoke the grazing rights; on the issue of "authority" the Court said:

"It is suggested that if the alleged acts are non-discretionary, they could not, perforce, have been committed within the scope of employment. A principal is liable civilly for the tortious acts of his agent which are done within the course and scope of the agent's employment even though the principal did not authorize, ratify, participate, or know of such misconduct. But a principal is not liable to third persons for torts committed by his agent acting outside the scope of his employment. If the agent goes outside his employment and *acts not in furtherance of the principal's business but to effect some purpose of his own*, the principal is not liable." (Italics supplied.)

The Circuit Court in the *Oman* case sent the case back for a determination of the issue of the purpose of the employee, as a question of fact.

Thus the case holds that the *same test* which California applies to determine whether or not an act is within the scope of private employment applies to

determine whether a Federal employee is within the scope of his employment—*furtherance of the business of the employer. Lack of authority, even an express order not to do the act done, does not determine or affect the scope of employment* of either a private or a Federal employee.

Nor should “authority” make a difference to the instant case.

Yet, as has been pointed out, this is precisely the ground of the opinion of the District Court in this case.

In that opinion (Transcript p. 11, 2nd paragraph) the Court states:

“The first question to be considered is therefore, what was the ‘scope of authority’ or ‘line of duty’ of the Commanding Officer and the physicians who attended Miss Cannon?”<sup>3</sup>

and (Transcript p. 12, second paragraph):

“There is no question but that the Government of the United States acts only through its agents with power delegated and defined by statute or regulation, \* \* \*”

It is submitted that under the authority cited, this position is clearly wrong, and the action taken by reason of this holding should be reversed.

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<sup>3</sup>The phrase “line of duty” does not restrict the extent of “scope of employment,” but has been held in *Hubsch v. U. S.*, 174 Fed. (2d) 7, and *U. S. v. Campbell*, 172 Fed. (2d) 500, to be equivalent to, though not broader than, “scope of employment”.

## IV.

**THE FEDERAL GOVERNMENT OWED PLAINTIFF THE DUTY OF CAREFUL TREATMENT ONCE HER TREATMENT HAD BEEN UNDERTAKEN AT DeWITT HOSPITAL.**

Implicit in Judge Goodman's opinion in this case, and underlying his action herein, though perhaps not put into words, is the feeling that because plaintiff's admission to DeWitt General Hospital was in excess of the authority of its commanding officer, the Federal Government owed no duty of care to plaintiff.

It is submitted that there is a duty of due care imposed on the owner of a hospital whose employees have undertaken the care of a patient—the duty to avoid injury to the patient by *negligent act*, when her presence is known.

In *Sessions v. Southern Pacific* (1911), 159 Cal. 599, a conductor of defendant railway permitted plaintiff to ride defendant's train without paying fare, a wilful and knowing violation of company rules, by both plaintiff and the conductor. The train was wrecked by the negligence of defendant's employees.

The California Court held that because trespassers were owed no other duty than the duty to refrain from "wilful and wanton neglect", and because plaintiff had not shown such neglect, plaintiff could not recover.

This, of course, was the Tort rule which further, more modern, judicial thinking has discarded, in California as elsewhere. The modern California rule, as to trespassers whose presence is known, is contained in *Oettinger v. Stewart*, 24 Cal. (2d) 133, which holds



that a known trespasser is owed a duty of due care in the conduct of the landowner's activities, however slight the duty of a landowner is with respect to the condition of the land on which the trespasser comes. *Restatement of Torts*, Sec. 346, is additional and persuasive authority for this position, *where, as here*, the trespass is not the result of an invitation by the negligent employee. See also *Restatement of Agency*, Sec. 242, comment a.

*Schuyler v. U.S.*, 227 U.S. 601, while not a California case, is closer to the present facts than any case found, and is persuasive authority here.

In that case, plaintiff obtained passage on defendant's train by use of a pass whose use was forbidden by the Hepburn act, though both plaintiff and defendant in good faith thought otherwise. Plaintiff was injured by the negligence of defendant's employees, and was allowed to recover though defendant urged his lack of right to passage, and that he was, in that respect a "trespasser" on the service of defendant, much as plaintiff here was assumed to be a "trespasser" on the service of the hospital.

The Court in the *Schuyler* case held that plaintiff though not on the train by right, was nevertheless not an outlaw; so here, it must be said, that even though plaintiff had no right to service at this hospital, she was not an outlaw therein, and was entitled to care in the service which was rendered to her by defendant's employees.

Even if the Federal Government was a mere volunteer in assuming treatment of plaintiff, the current



of tort law in California is to impose a duty of careful treatment on the volunteer once treatment is begun. Though no duty to treat is owed, yet a private person who assumed to treat plaintiff would render himself liable under current holdings for doing so negligently.

Thus in *Griffin v. County of Colusa et al.*, 44 Cal. App. (2d) 915, it was held that a mere volunteer assuming to treat a patient who had no right to such treatment owed the duty of careful treatment when treatment was once begun. The Court there said (44 Cal. App. (2d) p. 923, bottom):

“When one has undertaken to render assistance or care, even as a volunteer, the law imposes a duty of care towards the person assisted (Restatements of Torts, Sec. 324).”

Liability of the County of Colusa, the employer of the volunteer, was denied on the ground that California law still includes the doctrine of sovereign immunity from suit, which the Federal Government has, of course, specifically waived by the Tort Claims Act. See also *Sylva v. Providence Hospital*, 14 Cal. (2d) 762, at p. 765, also citing *Restatement of Torts*, Sec. 324.

Whatever plaintiff's status was vis-a-vis the Federal Government which owned and operated DeWitt General Hospital, and directed the activities of its personnel, even if she was a trespasser, therefore, once the Federal Government undertook to treat her, it was under a duty to treat her carefully.

## V.

THE ADMISSION OF PLAINTIFF TO DeWITT HOSPITAL WAS  
AUTHORIZED BY THE APPLICABLE ARMY REGULATIONS.

It is admitted that DeWitt General Hospital was an Army hospital, conduct of which is governed in part by Army Regulation 40-590, a copy of which was furnished the District Court, and the District Court took judicial notice, though it was not introduced into evidence.

The records of DeWitt Hospital (Plaintiff's Exhibit No. 3, p. 1), show the basis for plaintiff's admission to DeWitt as Par. 6b (13) A.R. 40-590. A.R. 40-590 provides:

"Sec. 2. *General Duties of Commanding Officer*  
\* \* \* \* \*

(b) Patients.

1. The Commanding officer, or one of the commissioned assistants will determine *which patients are to be admitted or discharged from the hospital.*

\* \* \* \* \*

Sec. 6. *Who may be admitted to Army Hospitals*

\* \* \* \* \*

(b) *List*

\* \* \* \* \*

(13) Civilian employees of the United States Government compensable by the United States Employee's Compensation Commission who suffer personal injury while in the performance of official duty, or who acquire a disease as a natural result of such injury, or who acquire an occupational disease, in the performance of official duty."

Likewise pertinent, though not contained in *A.R. 40-590* is *Sec. 77.2, of Title 10, Code of Federal Regulations* (now found re-codified in *Chapter 5 of 32, Code of Federal Regulations*, since the unification of the former Departments of War and Navy). This section provides:

“Sec. 77.2 *For whom authorized.* Under the conditions indicated herein, the Army will, usually through its own facilities, provide medical attendance to the personnel enumerated in Paragraphs (a), (b), and (c) of this Section.

\* \* \* \* \*

(c) *Civilian*

\* \* \* \* \*

(4) Civilian employees of the Army at stations where other medical attendance cannot be procured.

(5) Civilian employees of the United States government who receive personal injuries in the performance of official duties who may report for treatment at any Army dispensary or hospital upon request of the officer under whom they are employed, provided other government hospitals for treatment of such employees are not convenient of access.”

Clearly the decision as to whom to admit to an Army hospital is placed, originally, within the jurisdiction of the commanding officer. The words of the regulation themselves make this clear; indeed, any other administrative device might well result in loss of life, or great hardship, while a more ponderous proceeding was held to determine whether or not a particular civilian was admissible to an Army hospital.

As the record shows, Colonel Smith decided, from the facts available to him, that plaintiff qualified for admission as a civilian employee who had contracted an occupational disease in the performance of her official duties. What facts were before Colonel Smith when he decided this, of course, are not known to this Court, and were not known to the District Court. Evidence that plaintiff's varicose veins were made worse by her service with the Army is contained in the record of this case (see Transcript p. 45, center of page). No evidence was introduced by any party tending to show a lack of connection between the worsening of plaintiff's condition and her employment by the Army.

It is submitted that it does not lie within the power of the District Court to substitute its finding on the question of fact of causal connection between plaintiff's disease and her employment for the finding of the administrative officer to whom Congress has committed the task of deciding it. To do so violates the fundamental principle of administrative law that the judiciary will not assume executive or administrative duties, and will not (in the absence of fraud, or such mistake of fact as to amount to arbitrariness), remake a decision which an executive officer, acting within his jurisdiction, has once made and acted upon. Every reason advanced by the Court in support of this principle weighs against such judicial interference with the performance of a purely executive function. By such interference, the Court assumes executive functions; it shows disrespect to a coordinate branch of the Federal Government; it meddles in



questions about which it has less information than the executive officer who has made the decision; it exceeds the jurisdiction conferred upon it by Congress.

If authority to support so self-evident a proposition is needed, 42 Am. Jur., Public Administrative Law, Sec. 211, and particularly *Meadows v. U.S.*, 281 U.S. 271, and *U.S. v. Williams*, 278 U.S. 255, both dealing with executive decisions as to veterans' benefits, no judicial review of which was provided for.

It is submitted that the scope of review of this decision to which the District Court should have confined itself is limited to the question of whether the decision to admit plaintiff was so plainly unsupported by any evidence as to be outside the power of Colonel Smith to make; it is submitted that no Court could decide that his decision to admit plaintiff was altogether without support and that at the very worst, Colonel Smith had jurisdiction to err in making it, and was within his authority when he made it.

Other arguments could be made in support of the position that this decision to admit plaintiff was given insufficient weight by the District Court in this case; the well-known presumption that an administrative officer did not violate his duty, in making the decision under attack, the principle that a decision collaterally attacked, as this decision has been attacked, may only be attacked for fraud, or for complete lack of jurisdiction, might both be called to the support of Colonel Smith's decision. Fundamentally, they are both corollaries of the point made above—that the executive agent whose task it is to make a decision must be al-



lowed to make it without judicial interference, except where the decision is clearly wrong. The conduct of a government which depends on so many executive decisions would otherwise be impossible.

Because the employees who injured plaintiff were acting within the scope of their employment, and because plaintiff's admission to DeWitt General Hospital was authorized, it is clear that the action of the District Court should be reversed, and the case remanded for a new trial.

Dated, San Francisco, California,

June 12, 1950.

Respectfully submitted,

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No. 12,394

IN THE

United States Court of Appeals  
For the Ninth Circuit

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MYRTLE CANON,

VS.

UNITED STATES OF AMERICA,

*Appellant,*

*Appellee.*

APPELLEE'S REPLY BRIEF.

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FILED

2 - 1950

P. O'BRIEN,

CLERK



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**APPELLEE'S REPLY BRIEF.**

---

**THE FACTS.**

The findings of the trial Court set forth the facts in this case and as these are amply substantiated by the evidence and are not controverted on this appeal except as to findings that the employees of the Government (p. 4 of App. Brief) were not acting within the course and scope of their employment, we set forth these findings as the facts of the case with the exception of all findings relative to acting within the course and scope of their employment, which are eliminated. Therefore we present the following as the facts of this case:

That plaintiff was a civilian medical secretary employed by the United States at the De Witt General Hospital at Auburn, California, a hospital operated by the Medical Department of the War Department of the United States.

On June 14, 1945, plaintiff was operated upon in said hospital for varicose veins in her legs, a disease or ailment with which she had been afflicted for some time and which was in no way caused or contributed to by her employment. The operation was performed by Dr. E. William Rector, with the permission of Colonel William Smith, Commanding Officer of said hospital. Plaintiff received post-operative treatment from both Dr. E. William Rector and Dr. Norman Freeman, chief of the vascular section of said hospital.

Subsequent to said operation an infection appeared at the site of the operative wound. A course of treatment consisting of medication, irrigation of the infected area, and a series of operations, was instituted by the attending doctors in an attempt to arrest and cure the infection. In spite of such course of treatment the infection continued to spread and developed into a phagedenic ulcer, a rare and unusual disease. This ulcer continued to spread over the plaintiff's body during the entire time she remained under treatment at De Witt General Hospital until about November 24, 1945, at which time she was discharged from said hospital by reason of the fact that it was being deactivated by the Medical Department of the

United States Army, and thereafter while she was successively a patient at the University of California Hospital in San Francisco, California, the San Francisco City and County Hospital, and two hospitals in Los Angeles, California. At the time of trial herein, the said ulcer was not yet completely healed.

The course of treatment given to the plaintiff after the appearance of the infection was the usual, ordinary and recognized treatment customarily given by physicians and surgeons practicing medicine in the State of California at that time in similar cases of post-operative infections. The same course of treatment has been continued by plaintiff's present attending physician up to the time of the trial of this action.

During the time she remained in De Witt General Hospital subsequent to the operation performed upon her on June 14, 1945, plaintiff was afforded the usual and ordinary care and attention customarily afforded to patients in her physical condition by hospitals operated at that time in the State of California, and by doctors, nurses and attendants employed therein.

During the time she was under treatment at the De Witt General Hospital subsequent to said operation, plaintiff on numerous occasions handled the dressings applied to the site of the ulcer, and on several occasions touched and scratched the infected body areas and removed the bandages placed thereon.

The operation performed upon plaintiff on June 14, 1945, and all of the subsequent operations performed

upon her at the De Witt General Hospital were performed by the attending doctors in accordance with accepted and general recognized techniques, and with the degree of care, skill and learning usually and ordinarily employed by surgeons practicing at that time in the State of California.

On June 14, 1945, and at all times subsequent thereto while plaintiff remained in the De Witt General Hospital, the said hospital was operated by the Medical Department of the War Department of the United States under army regulations promulgated by the Secretary of War through the Chief of Staff, United States Army, including Army Regulations No. 40-590.

All of the employees of the United States of America who participated in any degree in the operations upon, hospitalization of, care of, or treatment of plaintiff, at all times exercised at least ordinary care and employed at least ordinary skill and learning in performing said operations, and in providing said hospitalization, care and treatment to plaintiff, and were not guilty of negligence, wrongful act or omission.

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### THE QUESTION.

The substantial questions presented by the appellant are:

If the acts of the Government employee constitute negligence (the trial Court found they did not) were these acts in the course and scope of his employment?

Did the trial Court err in finding, among others, that the acts were not in the course and scope of the employee's employment?

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### THE LAW.

As only one question is raised, and this Court is only called upon to interpret the law on the sole question of the course and scope of employment, we briefly review the law relative thereto.

Basically, the appellant was required to establish primary facts in order to give this Court jurisdiction, to-wit:

(a) That the persons who caused the injuries were employees of the United States at the time of the accident.

(b) That he was acting within the course and scope of his employment in the performance of the acts complained of.

(c) That the employee was not acting in a discretionary function or duty.

As stated in

*Hubsch v. U.S.*, 174 Fed. (2d) 7:

"We must reject the contention that judgment can be fastened upon the United States under the Federal Tort Claims Act solely because a servant of the Government negligently drove a vehicle belonging to the Government which had theretofore been entrusted to such servant, with-



out regard to whether such servant was acting within the scope of his duty. We come to this conclusion even though the statute undertakes to put the Government in the same situation as a private person would be under the law of the place where the accident occurred. It must be kept in mind, however, that statutes waiving the immunity of the sovereign to be sued must be strictly applied. *Rambo v. United States*, 145 F. 2d 670, and *U.S. v. Durrance* (5 Cir.), 101 F. 2d 109, wherein it was stated:

‘An action against the United States may be maintained only by its permission, and a statute dealing with the relaxation of sovereign immunity from suit must be strictly construed. Governmental liability should not be extended beyond the plain language of a statute authorizing it. *Schillinger v. United States*, 155 U.S. 163, 15 S. Ct. 85, 39 L. Ed. 108; *Price v. United States*, 174 U.S. 373, 19 S. Ct. 765, 43 L. Ed. 1011; *United States v. Michel*, 282 U.S. 656, 51 S. Ct. 284, 75 L. Ed. 598; *Munro v. United States*, 303 U.S. 36, 41, 58 S. Ct. 421, 82 L. Ed. 633.’

‘It must also be noted that the Tort Claims Act confers jurisdiction upon the Court to hear claims against the United States ‘on account of damage \* \* \* caused by the negligent or wrongful act or omission of an employee of the Government *while acting within the scope of his office or employment* \* \* \*.’ (Emphasis added). There can, therefore, be no jurisdiction in the Court to hear and determine claims against the Government under the Federal Tort Claims Act for any injury caused by the negligence of an employee

who was not acting within the scope of his employment. That is to say, the Government has not consented to be sued or to be liable for injuries caused by the negligent acts of its employees who are in and about their own personal and private enterprises. The Court would have no jurisdiction to try a tort action against the United States which was not based upon acts within the scope of the employment or duty of a servant. *Cropper v. U.S.*, 81 F. Supp. 81; *Long v. U.S.*, 78 F. Supp. 35; *Rutherford v. U.S.*, 73 F. Supp. 867."

\* \* \* \* \*

"There being no competent evidence in this case that the driver of the jeep was on the occasion in question in and about the business of the Government, and also no applicable presumption to that effect, it necessarily follows that the cases of the plaintiffs must fall and the judgments of the lower Court should be, and the same are hereby, **AFFIRMED.**"

We admit (a) that the persons allegedly causing the injuries were employees of the United States, but deny (b) in this case.

We do not desire to repeat the clear and logical memorandum opinion of the learned trial Court, as the Court will read it, but we will try and limit our brief to an extenuation of that opinion.

Perhaps we should point out that the trial Court in its opinion, through inadvertence or stenographic error, the name of Col. Smith was used on pages 2, 4 and 5. This should have been Colonel Stark, and

Colonel Stark, who was only the head of a section, not the commanding officer, stated according to appellant's testimony, that the hospital would perform the operation for her. (R.T. 47.) However, as stated by the trial Court in its opinion, A. R. 40-590 defines or classifies persons who are entitled to receive treatment in Army Hospitals, as follows:

“6. Persons who may be admitted to Army hospitals (provisions of this paragraph do not apply to the Army and Navy General Hospital (see AR 40-600)—When suitable facilities for hospitalization are available, sick and injured persons enumerated below may be admitted to Army hospitals.

a. The following personnel of the Army:

- (1) Officers, male and female (active or retired) (including Philippine Scouts).
- (2) Warrant officers, male and female (active or retired) (including Philippine Scouts).
- (3) Flight officers.
- (4) Army nurses (active or retired).
- (5) Cadets of the United States Military Academy.
- (6) Militarized female personnel of the Medical Department.
- (7) Aviation cadets.
- (8) Contract surgeons serving full time.
- (9) Enlisted men and women (including Philippine Scouts).
- (10) Retired enlisted men.”

It is clear that appellant doesn't come within any of the above classifications. Therefore she was not entitled to, nor could appellant be admitted as a patient under the law. Army Regulations have the same force and effect as law in such cases. See

*Hironimus v. Durant*, 168 Fed. (2d) 288;

*Gratiot v. U.S.*, 45 U.S. 80;

*Ex parte Reed*, 100 U.S. 13.

If she could not be admitted as a patient under the law, it must follow that the acts of any employees of the Government were not within the scope of their employment. They were not hired to treat people who were there illegally or through the goodness or caprice of the person in charge, or a person in charge of a small sector of the hospital, as in this case. If this was so, carried logically to its conclusion, the Army hospitals would be obligated to treat anyone who as an employee of such hospital desired to be treated, or who thought they should be treated.

We agree with appellant that the law of the place where the act occurred governed, but only in the light of the Tort Claims Act itself and the interpretation placed on that Act by the Federal Courts, and that a Federal Court's decision on that subject takes precedence over a State Court decision. It is still a Federal law. Government liability should not extend beyond the plain language of a statute authorizing it, and being a relaxation of sovereign immunity, should be strictly construed. It is conceded, we think, that the Court does not have jurisdiction to try a



Tort action against the United States which is not based upon acts within the scope of his employment.

In

*U.S. v. Evelyn Campbell* (U.S.C. of A.—5th Circuit No. 12368, decided 2/11/48), ..... Fed.

(2d) ....., *citation not available*,

plaintiff filed a tort action against the Government alleging she was knocked down by a sailor running to catch a troop train and permanently injured. She alleges the sailor was “acting in line of duty”. The Court denied the claim, stating:

“The whole structure and content of the Federal Tort Claims Act makes it crystal clear \* \* \* Congress was undertaking with the greatest precision to measure and limit the liability of the Government \* \* \*. The very heart and substance of the Act is to be found in the words ‘scope of his office or employment’.”

There is no evidence that it was within the scope of the Government employees to care for appellant nor any evidence of wrongful act or omission within the scope of their employment. On the contrary, the evidence shows that such alleged acts were outside of their employment. The Government did not derive any benefit. On the contrary, appellant used a bed which was apparently needed and at the expense of the Government. In

*Curio v. Nelson Display Co.*, 19 C.A. (2d) 46, 64 Pac. (2d) 1158,

it is held that if the agent’s acts are not for the benefit of the employee, or connected in any way with the



purpose thereof, but are for the employee's personal benefits, his acts are not within the scope of his employment. In

*Westberg v. Willde*, 14 Cal. App. (2d) 360, 94  
Pac. (2d) 590,

the Court stated:

"The pursuit of the master's business continued to be the controlling purpose".

We do not find in the record any permission of the commanding officer to hospitalize appellant nor any permission given to the employees, nor could any permission be implied or follow from the Army Regulations on the scope of employment of Lt. Col. Stark.

Appellant apparently concedes (p. 7 of brief) that the act must be done "in furtherance of the purpose of the employment"; that Lt. Col. Stark, the head of a section of the Army Hospital (not the head or the commanding officer, of the hospital—Colonel Smith), said "\* \* \* it would be my (appellant) responsibility to see that the section ran smoothly until Major Freeman got his feet on the ground \* \* \*" (p. 46); that when appellant mentioned she wanted to have an operation for varicose veins, Lt. Col. Stark told her "\* \* \* we will do it here for you \* \* \*" (p. 47); that "Major Freeman came in and I worked with him for about six weeks and then he left and took a month leave" (p. 49).

The commanding officer in the Army is the sole person responsible for the Unit. He alone could determine whether or not his retention was for the pur-

pose of the Government but he did not do so. Appellant knew this (p. 48) or certainly should have known. She knew, or certainly should have known, that she had no right to be operated on in an Army Hospital; that the hospital was for Army personnel only; that she was, as far as the Government was concerned, a trespasser. She knew she was not obligated to pay for the operation. It would be stretching the imagination to say that it furthered the Government purpose to have her operated upon. Even if Lt. Col. Stark considered her operation desirable or necessary until Major Freeman "had his feet under him", that was accomplished before he left for his vacation. Violation of the Federal law cannot be said to be "furthering the purposes" of the Government.

Appellant cited

*Stansell v. Safeway Stores, Inc.*, 44 C.A. (2d)

822,

an Appellate Court decision. However, we do not think the facts are in point in this case. A somewhat similar case to the one cited, but a Supreme Court case, is

*Rahmel v. Lehdorff*, 142 Cal. 681, 76 Pac. 590, which would seem more in point, if at all, than the case cited.

It was not Lt. Col. Stark's job with the Government to hire personnel, nor to admit them to the hospital. If he did so, he departed from the scope of his employment.

Appellant seeks to draw a distinction between authority and scope of employment. We think the line

of demarcation is arbitrary on her part. How could the scope of employment be separated from authority? The authorized acts determine the scope of employment. One cannot disregard authority and say it is in the scope of employment. No cases to that effect were cited by appellant. The *Stansell* case holds, as we interpret it, that the wrongful act *must* be a part of the transaction of the authorized business. But here it was not a part. Lt. Col. Stark was not engaged in the work of the Government, for which he was hired, when he permitted an unauthorized person to be hospitalized. The nature of the act, the historical interpretation of the intent of Congress, the strictness of such interpretation when it relinquishes the right of a sovereign, all tend to the conclusion that only such acts are within the scope of employment, as against the Government, when the employee is authorized or actually acting within his prescribed authority. This is illustrated by the fact that estoppel does not lie against the Government. We will further follow this under our next heading.

*As to (c):*

“Sec. 421. The provision of this title shall not apply to (a) any claim based upon an act or omission of an employee of the Government \* \* \* based upon the exercise or performance \* \* \* of a discretionary function or duty \* \* \*”.

Here again the law must be interpreted according to the intent of Congress and not solely guided by the law of California. It is obvious that Congress did not intend that the employees would go out of

their scope of employment, as delineated and definitely *laid down by proper authority*, and even went so far as to say that even under such proper authority, if *it is discretionary* with the employee (as against a direct command or direction to do a certain thing), it is an exception to the Tort Claims Act. So, looking at it in the best light for plaintiff we find—

The employee in this case had no authority to admit appellant. (This is, we believe, admitted.) At the best, it was a discretionary function. But the Government is not liable for any discretionary functions of its agents. In

*Denny v. U.S.*, 171 Fed. (2d) 365,

the Court held medical treatment proffered to dependents of military personnel was a discretionary function of a commanding officer and the Government could not be held liable.

Under the Army Regulations, dependents could be treated at Army Hospitals, hence this is a much stronger case in favor of the Government than the case at bar, for surely if the Government is not liable when it is discretionary, it is not liable when forbidden.

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### THREE OTHER POINTS.

1. May we point out that the Government is not liable even if we are wrong in all or any one of the above. The appellant was bound to show negligence on the part of the officers or agents in the selection



of the surgeon to perform the operation. This is the rule applicable to employers who voluntarily furnish needed attendance to their employees.

*Vesel v. Jardine*, 127 A.L.R. 1092, 100 Pac. (2d) 75.

This was not done.

2. The appellant being a federal employee, her exclusive remedy is in The Federal Employees' Compensation Act.

See

*Parr v. U.S.* (1/21/49, 10 C.A.), 172 Fed. (2d) 462;

*Jefferson v. U.S.*, 77 F. Supp. 706;

*Hokensen v. U.S.* (N.D. of C.). Judgment in favor of deft. entered April 19, 1949;

*Dahn v. Davis*, 258 U.S. 421.

Since the decisions in these cases the law has been amended to make the Act exclusive.

3. If the trial Court erred in its particular finding that the acts were not in the *course* and *scope* of the employee, then the other findings of a total lack of negligence must still stand and the judgment would still stand against the appellant.

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#### APPELLANT'S BRIEF.

Appellant's brief, although displaying great ability in "building" a case, however disregards, we believe, certain fundamental matters.



(1) The appellant had put in her entire case. The trial Court dismissed the action in accordance with the findings of fact and conclusions of law and not solely on grounds of scope of employment.

(2) The disregard of certain principles of law inherent in a federal statute which are not voided by the Act or because of the phrase "law of the place where the act occurred".

As Chief Justice Vinson, in the *Aetna Casualty & Surety Co.* case, cited by appellant, said:

"\* \* \* neither the terms of the Act nor its legislative history preclude the application of R.S. 3477 in this situation".

Some of these principles are:

Individuals as well as Courts must take notice of the extent of authority conferred by law upon a person acting in an official capacity and the rule "ignorance of the law furnishes no excuse for a wrongful act" applies in this case.

*State v. Hayes*, 52 Mo. 578;

*Delafield v. State*, 26 Wend. 238;

*People v. Bank*, 24 Id. 431;

*Mayor v. Reynolds*, 20 Md. 10.

The Government can function only through the acts of its agents acting *within the limits* of their lawful authority.

*Floyd's Acceptance*, 7 Wall. 666.

Were the rule otherwise, there would be no limit to the obligations which might be imposed upon the Government from the unauthorized acts of employees

purporting to act according to their concepts of what might be generally in the public interest, or otherwise. Estoppel does not lie against the Government.

*Wilbur, etc. v. U.S.*, 294 U.S. 120, 123.

Those dealing with the agents of the United States are held to have notice of the limitation of their authority.

*Utah, etc. v. U.S.*, 243 U.S. 389, 409;

*Sutton v. U.S.*, 256 U.S. 575, 579;

*Oregon v. U.S.*, 238 U.S. 393.

The intent of Congress in passing this Act: one of the principal reasons, as stated by appellant on page 10, was to relieve Congress of passing on private bills which heretofore had rarely exceeded \$5000.

(3) Appellant states (p. 6), "These doctors and nurses were doing precisely what they had been hired to do." In treating appellant they were doing precisely what they *were not* hired to do. They were hired solely to take care of Army personnel except civilian employees compensable by the United States Employees' Compensation Commission "who suffered personal injury *while in the performance of official duty*". (Italics ours.) Appellant cites this on page 16 of her brief but there are two things which remove this citation from this case (a) "compensable by the United States Employees' Compensation Commission" (b) "in the performance of official duty." Clearly neither of these has been proved as a fact.

Appellant further cites Sec. 77.2 of Title 10, Code of Federal Regulations (p. 17) as showing that ap-

pellant's admission was authorized. This does not appear in Army Regulations, by which the Army personnel is governed. Moreover, from the partial citation itself, it is apparent that it is discretionary at the most, and hence excepted to by the Act.

Appellant further says the decision is placed with the commanding officer; that Col. Smith found appellant qualified for admission and that the District Court can not substitute its findings for those of the Commanding Officer. The answer is, that only within the Army Regulations is the decision of the commanding officer placed; we couldn't find in the record that Col. Smith, the Commanding Officer, had found, qualified or admitted her; that the Court is the proper forum to determine such alleged disputes as in this case. This is not an executive decision such as is referred to in the cases cited by appellant.

(4) The authorities cited do not refer to the Federal Tort Claims Act and reference to such cases should be guarded (see *supra*). The Restatement of Agency is not regarded as authority under the Act in question. To permit an employee who is unauthorized, to bind the United States, would open a field of liabilities that, carried out to its extreme, could bankrupt the United States and certainly was not the intent of Congress. The *Aetna Insurance Co. v. U.S.* case, cited on p. 10, we believe, simply stated that assignments by operation of law could be sued upon. It still retained the old law relative to other assignees being incapable of obtaining jurisdiction

under the old law (1875?). It illustrates that other federal laws should be taken into consideration.

(5) Referring to p. 13 of appellant's brief. The trial Court found it was not within the scope of authority and that there was no negligence. Appellant quotes *Sessions v. Southern Pacific*, 159 Cal. 599 (p. 13), and says this was the Tort rules which had been discarded and it is now superseded by the rule in *Oesttinger v. Stewart*, 24 Cal. (2d) 133. We could not find the *Sessions* case overruled or the rule distinguished by any subsequent cases. The following quotation from the syllabus of that case may interest the Court as appellant is, in our opinion, a trespasser.

“Id.—Collusive Arrangement for Passage with Conductor—Notice of Want of Conductor's Authority.—A person riding on a train without payment of fare, in pursuance and with knowledge of an arrangement made between the conductors thereof, whereby he was given an expired pass running to one of the conductors which he was to present to the conductor in charge of the train, who was to punch and return it as if it were a ticket, is charged with notice, as a reasonable man, that it was contrary to the rules of the railroad company to allow him free passage. The status of a person so riding is that of a trespasser and not that of a passenger, and the company is not liable for causing his death unless it has been guilty of willful or wanton injury.”

We believe the distinction between the *Oesttinger* case and this case is so marked that it requires no comment from us.

**CONCLUSION.**

This case was fully and fairly tried. Appellant had her day in Court and submitted all the evidence she desired. The judgment should be affirmed.

Dated, San Francisco, California,  
August 2, 1950.

Respectfully submitted,

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No. 12,394

IN THE

United States Court of Appeals  
For the Ninth Circuit

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MYRTLE CANON,

vs.

UNITED STATES OF AMERICA,

*Appellant,*

*Appellee.*

APPELLANT'S REPLY BRIEF.

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**FILED**

AUG 18 1950

**PAUL P. O'BRIEN,**

**CLERK**



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---

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**APPELLANT'S REPLY BRIEF.**

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**I. NO FINDING WAS MADE BY THE TRIAL COURT ON THE  
ISSUE OF NEGLIGENCE.**

Much of appellee's brief is devoted to the assertion that plaintiff failed to prove negligence on the part of defendant's employees or agents. The findings of fact made by Judge Goodman expressly omit determination of this issue. (Findings XVIII to XXIV inclusive, Record pp. 21-23, particularly Finding XXIV at p. 23.)

In passing, however, it may be noted that the rule is that on a motion to dismiss or for nonsuit plaintiff's evidence must be accepted as true, and plaintiff is entitled to the most favorable inferences deducible from the evidence.

*Thompson v. Irrigation District*, 227 Fed. 560;



*Hotel Woodward Co. v. Ford Motor Co.*, 258  
Fed. 322;  
*Boal v. Electric Storage Battery Co.*, 98 Fed.  
(2d) 815.

In the light of this rule defendant's motion to dismiss could not be sustained in the face of the testimony given by Dr. Esnard. (Record pp. 72-80.)

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**II. THE DOCTORS AND NURSES WHO TREATED PLAINTIFF WERE ACTING WITHIN THE SCOPE OF THEIR EMPLOYMENT.**

Reference is made to the arguments advanced in appellant's opening brief, pages 6-9.

The position of appellant receives further support from the testimony at pages 47-48 in the Record, in connection with which this Court should have in mind the principle of law enunciated in the *Restatement of Agency*, Section 236:

“An act may be within the scope of employment, although done in part to serve the purposes of the servant or of a third person.”

Appellant desires to supplement the cases of *Stansell v. Safeway Stores*, 44 Cal. App. (2d) 822, and *Andrews v. Seidner*, 49 Cal. App. (2d) 427, cited as authority for the distinction between authority and “scope of employment”, with the following cases:

*Lane v. Safeway Store, Inc.*, 33 Cal. App. (2d)  
169 at pp. 172-173,

and

*McChristian v. Popkin*, 75 Cal. App. (2d) 249,  
at pp. 254, 255.

On this point appellee relies on *Rahmel v. Lehn-dorff*, 142 Cal. 681, but the statement in the *Rahmel* case that the wrongful act must be one which the servant is empowered under certain circumstances to do is expressly limited and repudiated in *Ruppe v. City of Los Angeles*, 186 Cal. 400 at p. 402.

In support of its arguments on this point appellee cites several cases at pp. 16 and 17 of its brief but examination of these cases discloses that they all deal with "the power of an agent to bind the federal government to a *contract*, a field of agency law in which 'authority' is the key question." (Appellant's Opening Brief, p. 8, footnote 2.)

Appellee asserts (Appellee's Reply Brief, pp. 7 and 11) that there is nothing in the record indicating that the Commanding Officer, Col. Smith, gave his permission to the admission of plaintiff to the De Witt Hospital. The record is to the contrary. (Appellant's Opening Brief, p. 3; Record, p. 49; Plaintiff's Exhibit 3, p. 1.)

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### III. THE ADMISSION OF PLAINTIFF TO DE WITT HOSPITAL WAS AUTHORIZED BY THE APPLICABLE ARMY REGULATIONS.

It is not admitted as stated in appellee's reply brief, page 14, that "the employee in this case had no authority to admit appellant". Point V and the argu-

ment thereunder of appellant's opening brief are devoted to the argument to the contrary.

In appellant's opening brief the correct citation for A.R. 40-590, Par. 6-b(13) was omitted. The correct citation is:

9 Fed. Reg. p. 11571; Title 10, Chapter VII, Code of Federal Regulations, Section 707.15 (b) (13).

Appellant's opening brief cited at page 17 as likewise pertinent to this point, Section 77.2 of Title 10, Code of Federal Regulations. The correct citation for this section is Title 10, *Chapter VII*, Code of Federal Regulations, Section 77.2.

This latter section was in effect upon the date of appellant's admission to De Witt Hospital in June, 1945. This section was enacted as Par. 2, A.R. 40-505, September 1, 1942, as amended March 2, 1943; 7 F.R. 7583, 8 F.R. 3281.

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#### **IV. THE FEDERAL GOVERNMENT OWED PLAINTIFF THE DUTY OF CAREFUL TREATMENT ONCE HER TREATMENT HAD BEEN UNDERTAKEN AT DE WITT HOSPITAL.**

The duty of care owed plaintiff at the DeWitt Hospital is to be measured by her status therein. Actually, plaintiff was a "licensee" or a "business visitor" depending upon whether or not the classification made by the California cases or the Restatement, Torts, is accepted. See *Boucher v. American Bridge Co.*, 95 A.C.A. 769, Jan. 20, 1950, at p. 777.

However, in appellant's opening brief for the purpose of argument we assumed the extreme that she could be regarded as a trespasser and pointed out that

even upon this assumption the defendant had failed in its duty to appellant. (Appellant's Opening Brief, pp. 13-15.) Appellee asserts (Appellee's Reply Brief, p. 19) that the rule in *Sessions v. Southern Pacific*, 159 Cal. 599, was not expressly overruled in the later case of *Oettinger v. Stewart*, 24 Cal. (2d) 133. Since the filing of our opening brief the District Court of Appeal has obliged appellee by expressly overruling the *Sessions* case in *Fernandez v. Consolidated Fisheries, Inc.*, 98 A.C.A. 89 at p. 95. The *Fernandez* case was decided June 13, 1950, and a hearing was denied by the Supreme Court August 10, 1950. That decision establishes it to be the law of the State of California that the duty of ordinary care established by Section 1714 of the California Civil Code applies to invitees, licensees and trespassers.

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**V. DEFENDANTS ARE NOT EXCUSED BY THE EXCEPTION IN THE FEDERAL TORT CLAIMS ACT FOR A DISCRETIONARY FUNCTION OR DUTY.**

Appellee argues that the government is not liable in this case for the reason that it was exercising a discretionary function within the exception in Section 421 of the Federal Tort Claims Act cited in *Denny v. U.S.*, 171 Fed. (2d) 365.

The answer to this contention is two-fold: As pointed out in our opening brief (p. 6, footnote 1) plaintiff's claim rests upon the negligent treatment of the doctors and nurses who treated her while they were acting within the scope of their employment, *and not upon the negligence of Col. Smith, the Command-*



*ing Officer of the hospital in admitting plaintiff.* This is in contrast to the situation in the *Denny* case where the claim for liability was predicated upon failure to admit plaintiff to an Army hospital as a breach of a duty upon the part of the admitting officers, found to be discretionary by the Court in that case.

Second, the language of A.R. 40-590, and of Section 77.2, Title 10, Chapter 7, C.F.R., indicates that the duty to admit in the proper circumstances is mandatory not discretionary.

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**VI. IT IS NOT TRUE THAT "APPELLANT BEING A FEDERAL EMPLOYEE HER EXCLUSIVE REMEDY WAS IN THE FEDERAL EMPLOYEES COMPENSATION ACT."**

Far from supporting appellee's position on this point the cases cited by appellee are to the contrary. Thus in *Parr v. U. S.*, 172 Fed. (2d) 462, it was expressly held that when the Federal Tort Claims Act was enacted the plaintiff in that case had two remedies for the same wrong. The same holding was made regarding the Federal Control Act of March 21, 1918 (40 Stat. 451) as it related to the Federal Compensation Act (39 Stat. 742) in *Dahn v. Davis*, 258 U.S. 421 at p. 428.

In both of those cases it was held that the plaintiff had elected to accept the benefits in the Federal Compensation Act and was therefore precluded from pursuing the alternative available remedy. In this case there is not the slightest evidence of an election on the part of plaintiff to accept the benefits of the Federal



Compensation Act; in distinction to the facts in the two cases above plaintiff made no claims for compensation and accepted no benefits payable under that Act. *An election was furthermore impossible, because the Federal Tort Claims Act was not effective until August 2, 1946, while plaintiff was admitted to the hospital in June, 1945.*

Nothing in either the Federal Compensation Act nor the Federal Tort Claims Act, where numerous other exceptions are set forth in Section 421, indicates that either is intended to be an exclusive remedy. Under the cases cited by appellee, therefore, in the absence of an election, plaintiff had a right to proceed under the Federal Tort Claims Act.

The decision in *Jefferson v. U. S.*, 77 Fed. Sup. 706 (Appellee's Brief, p. 15), is expressly limited to consideration of the rights of an enlisted man in the United States Army.

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#### CONCLUSION.

The judgment of the District Court should be reversed and the case remanded for a new trial.

Dated, San Francisco, California,  
August 16, 1950.

Respectfully submitted,  
HALLINAN, MACINNIS & ZAMLOCH,  
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